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Supreme Court of the United States

OCTOBER TERM, 1955

No. 255

MILLINERY CENTER BUILDING CORP.,
PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED JULY 22, 1955

CERTIORARI GRANTED OCTOBER 10, 1955

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1955

No. 255

MILLINERY CENTER BUILDING CORP.,
PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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[fol. 1]

THE TAX COURT OF THE UNITED STATES

21 T. C. No. 92

MILLINERY CENTER BUILDING CORP. (now Fashion Center Building Corp.), Petitioner

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

FINDINGS OF FACT AND OPINIONS.—Promulgated February 26, 1954.

1. Petitioner purchased land which it had under lease for a period of 21 years for a consideration of $2,100,000. The fair market value of the land was $660,000, if it had been unimproved on the date of purchase. Petitioner claims that the remaining $1,440,000 was paid to secure the cancellation of a burdensome lease which had 21 years to run. Petitioner claims deduction of the $1,440,000 which, it maintains, should be allocated to the cost of canceling the lease as an ordinary and necessary business expense under section 23(a) of the Code. *Held*, the $1,440,000 is not deductible in the year paid as an ordinary and necessary business expense. *Cleveland Allerton Hotel, Inc.* v. *Commissioner*, 166 F. 2d 805, reversing T. C. Memorandum Opinion, not followed.

[fol. 2] (2) In the alternative, petitioner claims that it should be permitted to amortize over the remaining term of the lease all that it paid in excess of the value of the land, if it had been unimproved at the time of purchase, as the cost of canceling a burdensome lease. *Held*, that petitioner, in procuring the cancellation of its lease as a part of the transaction in acquiring the land, did not acquire a capital asset in the cancellation of its lease and has no legal ground for the amortization deduction which it claims under its first alternative.

(3) In its second alternative, petitioner claims that all that it paid in excess of the fair market value of the land

in an unimproved condition should be allocated as additional cost of its building and that it should be allowed depreciation based on this additional cost spread over the remaining useful life of the building. *Held*, that petitioner already owned the building and had been permitted to recover by way of depreciation, including the amount of depreciation allowed by the Commissioner in the taxable year, the full amount of the cost of its building and has no unrecovered cost which it is entitled to recover by way of depreciation. It has no additional cost of its building by reason of the transactions here.

4. In the taxable year petitioner incurred and paid $16,500 attorneys fees in acquiring title to the land and cancellation of the lease. The Commissioner disallowed petitioner the deduction of said amount on the ground that it was a capital expense. *Held*, the expenditure was made in the acquiring of capital assets and is not deductible.

Bernard Weiss, Esq., and Sidney Gelfand, Esq., for the petitioner.

John J. Madden, Esq., for the respondent.

[fol. 3] The Commissioner has determined a deficiency in petitioner's excess profits tax for the year 1945 of $39,465.62. The deficiency is due to five adjustments made by the Commissioner to the income as reported by petitioner on its return. These adjustments were:

(a) Capital Stock Tax	$ 5,000.00
(b) Legal Expense	16,500.00
(c) Prepaid Rent	8.33
(d) Depreciation	15,579.32
(e) Net short term capital gain	1,899.38
Total	$39,087.03

Adjustments (b) is explained in the deficiency notice as follows:

> (b) Deduction of legal expenses, in the amount of $16,500.00, incurred in connection with the acquisition of your property has been disallowed because it represents a capital expense.

Adjustment (d) is explained in the deficiency notice as follows:

> (d) A reasonable allowance for the depreciation of your building and improvements is determined to be $65,339.57, rather than the amount of $81,099.89 deducted in your return.
>
> No allowance has been made with respect to a payment by you to allegedly obtain the cancellation of a lease, in the absence of information showing that a deductible business expense was incurred.

In its original petition petitioner made two assignments of error:

> [fol. 4] a) The Commissioner of Internal Revenue has failed to allow as a deduction an ordinary and necessary business expense in the amount of $1,600,000.00 incurred to secure a release from a 21 year lease with a minimum rental of approximately $225,000.00 per annum.
>
> b) Alternatively to sub-paragraph (a) above, petitioner contends the Commissioner of Internal Revenue has failed to allow an additional deduction for depreciation in the amount of $35,961.60.

At the hearing petitioner filed an amended petition changing paragraph (b) above and adding (c) and (d), as follows:

> (b) Alternatively to sub-paragraph (a) above, petitioner contends the amount paid in excess of the value of the land, namely $1,500,000, should be amortized over a period of 21 years. Commissioner of Internal Revenue has failed to allow a deduction for such amortization.
>
> (c) In the further alternatives to sub-paragraphs (a) and (b) above, Commissioner of Internal Revenue has failed to allow an additional deduction for depreciation in the amount of $36,000.00.
>
> (d) Commissioner of Internal Revenue has failed to allow as a deduction that part of the legal expense in the amount of $16,500.00 and sundry expense in the amount of 4,552.50 incurred in connection with

obtaining a release by the petitioner from its lease agreement with the landlord.

The respondent's other adjustments are not contested.

[fol. 5] FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioner is a corporation with its principal office in New York City. The returns for the period involved here were filed with the collector for the third district of New York.

On April 30, 1924, petitioner leased land located at the northeast corner of Seventh Avenue and 38th Street, New York City. The size of the plot is 98 feet 9 inches on the east side of Seventh Avenue and 200 feet on 38th Street. The lease provided for an annual net basic rental of $100,000, plus the income taxes that would be incurred by the lessor upon the receipt of the $100,000 per annum. The lease between petitioner and the landlord was amended on November 30, 1935, to provide for an annual net rental of $118,840 without petitioner being liable for reimbursing the landlord for any income tax thereon. On April 16, 1945, petitioner exercised the option contained in the lease agreement to extend the lease for a period of 21 years to April 30, 1966.

In accordance with the terms of the lease, the petitioner-tenant erected a 22-story loft building at a cost of $3,000,000, including taxes, interest and insurance during construction on the leased land. Title to the building, improvements and fixtures belonged to the tenant-petitioner. Title to this property was to vest in the landlord at the expiration of the last term of the lease only at the option of the landlord. In the event of the destruction of the building by fire or other causes, the petitioner-tenant was still liable on the lease and could not abandon the lease. In the event of the destruction, in whole or in part, of the building petitioner-tenant at its own cost had to make the building whole. At the expiration of the lease or any renewal period, petitioner-tenant was to surrender the premises and the building to the landlord at his option, [fol. 6] free and clear of all encumbrances, without the landlord being obligated to pay for such property. Peti-

tioner-tenant had the option to renew the lease for two successive 21-year periods. The ground rent for the renewal period was to be six per cent of the value of the land at the termination of each period of the lease but not to be less than the basic rent of $100,000, plus the additional rent of $18,840. The value of the land was to be determined as if vacant and unimproved. The rent at six per cent of the value of the land, in May 1945, would have been less than the minimum basic rental of $100,000.

On May 11, 1945, petitioner entered into an agreement of sale with Wendel Foundation, the owner of the land. Title to the land was taken by petitioner on June 11, 1945. Petitioner purchased the fee and obtained release from the obligations of the renewed lease for $2,100,000. Petitioner purchased the fee to be released from the terms of the lease. Petitioner was most concerned about the annual rental of $118,840, which it deemed excessive, and the contingent liability to remove the building from the premises at the expiration of the lease upon the request of the landlord. The agreement of sale between Wendel Foundation, the lessor and owner of the fee, and petitioner contained, among other provisions, the following:

> Witnesseth that the Seller agrees to sell and convey and the Purchaser agrees to purhase:
>
> [Here follows a description of the premises.]
>
> The price is Two Million One Hundred Thousand Dollars ($2,100,000) payable as follows: Two Hundred Ten Thousand Dollars ($210,000) on the signing of this contract, receipt whereof by check subject to collection is hereby acknowledged, the non-payment of which check in due course shall give Seller the option of cancelling this agreement; and the balance, One Mil-
> [fol. 7] lion Eight Hundred Ninety Thousand Dollars ($1,890,000) on the delivery of the deed as hereinafter provided, by certified check satisfactory to the Seller, the check to be drawn to the order of the Seller and payable through the New York Clearing House.
>
> . . . . . .
>
> Seller shall execute upon request of Purchaser an agreement cancelling and terminating said lease as

of the time of the actual closing of title hereunder. It is agreed however that regardless of whether Purchaser accepts title to the premises subject to the aforementioned lease or elects to have an agreement cancelling and terminating same, the idemnity [sic] agreements of Purchaser contained in the said lease shall continue in full force and effect after closing of title in favor of the Seller with respect to any liabilities or obligations of Seller assumed by or imposed upon it by the terms of the lease or any such agreements of amendment, modification, extension or renewal or arising out of Seller's ownership of the said premises.

* * * * * * * *

The deed shall be in proper statutory short form for record in the usual form of a Bargain and Sale deed containing no covenant or warranty and shall be duly executed and acknowledged by Seller at Seller's expense. * * *

The agreement of cancellation of the lease was executed June 11, 1945, and contains, among other things, the following language:

Whereas, the Tenant requested the Landlord to accept a surrender of the demised term and the Landlord agreed to accept such surrender provided this agreement was executed simultaneously with the execution of the formal agreement of surrender, which [fol. 8] formal agreement of surrender is being executed and delivered simultaneously herewith:

Now, Therefore, in consideration of the premises and the sum of One Dollar ($1.00) and other good and valuable consideration by each of the parties hereto to the other in hand paid, receipt whereof is hereby acknowledged, the parties hereto do hereby mutually release one another and their successors and assigns from any and all obligations under said lease and modification agreement and under said agreement of renewal and extension thereof. * * *

The land purchased by petitioner contained 19,750 square feet and was located in Block No. 814, bounded by 38th Street, Seventh Avenue, 39th Street, and Broadway. The Millinery Center Building and the land on which it stood were assessed for real estate tax purposes as follows:

	Land	*Building*	*Total*
1943-1944	$1,470,000	$2,305,00	$3,775,000
1944-1945	1,410,000	2,165,00	3,575,000

The remainder of Block No. 814, comprising 45,178 square feet and improvements thereon, was sold on December 2, 1943, for $1,250,000. This property had a frontage of 205 feet on the west side of Broadway, 301 feet on 39th Street, 165 feet on 38th Street, and 98 feet and 9 inches on Seventh Avenue, and was assessed for real estate tax purposes as follows:

	Land	*Building*	*Total*
1943-1944	$3,830,000	$115,000	$3,945,000
1944-1945	3,735,000	100,000	3,835,000

Lot 64 of Block No. 813 on the southeast corner of 38th Street and Seventh Avenue had the same frontage with [fol. 9] identical dimensions as the property in question and was located directly across the street. Lot 64 was offered for sale in 1945 for an amount less than $600,000 but remained unsold. That lot with improvements was previously sold on March 1, 1944, for $600,000. This property was assessed for real estate tax purposes as follows:

	Land	*Building*	*Total*
1943-1944, and 1945-1945	$1,225,000	$35,000	$1,260,000

Lot 55, Block No. 713 was leased in December 1924 by the landlord for a net basic rental of $115,000, plus the income taxes thereon, for a term of 21 years with two renewal options of 21 years each. The rental was changed to $138,000 in lieu of $115,000, plus the income tax thereon. Pursuant to the terms of the lease, the lessees had erected a 23-story building which was completed in 1926. The lease was renewed on April 26, 1945. On May 8, 1945, the

fee to the land, on which was the building erected by the tenant and subject to a long-term lease, was sold to the Woodmen of the World for $2,250,000.

In 1945, the United States Government restrictions on building construction, plus the restrictions contained in New York State rent laws adversely affected the value of land. Limitations Order L-41 restricting building construction became effective in 1942 and was still in effect through the year 1945.

The value of the land, vacant and unimproved, upon which the petitioner's property stood was $660,000 when purchased by petitioner in 1945.

Petitioner incurred legal fees aggregating $16,500 in connection with the purchase of the fee and the release from the obligations under its lease with the Wendel Foundation.

[fol. 10]

OPINION

BLACK, *Judge*: Petitioner states the issues raised by the pleadings, in its brief, as follows:

I

Is the petitioner entitled to deduct the amount of $1,500,000 or any part thereof incurred in connection with the cancellation of a burdensome lease as an ordinary and necessary expense under Section 23(a) or as a loss under Section 23(f) of the Internal Revenue Code? Or, in the alternative, is the petitioner entitled to amortize the said $1,500,000 or any part thereof incurred in obtaining a release from the burdensome 21 year lease over the remaining term of such lease?

II

In the further alternative, is the petitioner entitled to capitalize that part of the price paid of $2,100,000 over and above the actual land value as the purchase price of the building and depreciate said cost of building over the remaining building life of 30 years?

III

Is petitioner entitled to deduct that part of the $16,500.00 legal expenses incurred to acquire the fee and

See also, *Chas. A. Clark*, 19 T. C. 48; *Bagley & Sewell*, 20 T. C. 983.

[fol. 28] This Court itself has recognized that principle in *Helvering v. Community Bond & Mortgage Corporation*, 74 F. 2d 727, and in *Roscoe v. Commissioner*, 215 F. 2d 478. (Not previously cited to the Court). While the latter case is the contra to that of the Millinery Center Building Corporation, the principle is the same. In that case two stockholders sold all of their holdings in a real estate corporation with which the corporation had an exclusive contract to sell the realty subdivision. The amount received for the stock was in excess of the actual value. The sale contract was for a unitary amount for the stock but as part of the contract the taxpayers agreed to cancel their agreement of exclusive agency. This Court upheld the Tax Court in taxing as ordinary income that part of the selling price in excess of the value of the stock. This Court said whether the excess amount represented compensation for services or payment for cancellation of an undesirable contract, it would be ordinary income. The important point is that the Court looked through the form of a unit price to get to the substance and sustained an allocation between the amount received for the actual value of the asset being sold and for services or cancellation of a contract.

This principle of having the intent of the purchaser govern the taxability of the transaction as well as allocating a single purchase price to the purposes for the payment has also been recognized in tangible property and real estate transactions. Thus, in *Olympia Harbor Lumber Co. v. Commissioner*, 30 B. T. A. 114, the petitioner paid $7,900 to acquire certain equipment owned by the vendor with a value not in excess of $2,500, and with the purchase of said equipment a contract between the petitioner and the vendor was automatically terminated though not specifically stated. The difference of $5,400 was considered to be paid to rid [fol. 29] the purchaser of an unsatisfactory contract and the deduction was allowed.

Similarly there is a line of cases dealing with the acquisition of the stock of a company in order to acquire real estate and other assets wherein it has been held that although the stock was what was actually acquired, and all the rights

to cancel a burdensome lease that is applicable to the cancellation of the burdensome lease?

The principal issue in this proceeding is whether petitioner, a lessee in possession who purchases the fee and the cancellation of the lease for a price greater than the value of the land, may allocate a portion of the purchase [fol. 11] price to the purchase of the lease and deduct the allocated portion as a business expense under section 23(a). Respondent in his deficiency notice determined that "No allowance has been made with respect to a payment by you to allegedly obtain the cancellation of a lease, in the absence of information showing that a deductible business expense was incurred." Respondent still contends that no part of the purchase price of $2,100,000 paid by petitioner in 1945 to the Wendel Foundation can be deducted as a business expense nor is petitioner entitled to use any part of this purchase price as a basis for amortization or depreciation deductions. For reasons which we will presently give, we think respondent must be sustained in each of these contentions.

Business Expense

Petitioner paid $2,100,000 under the agreement of May 11, 1945, to the Wendel Foundation. Credible and uncontradicted testimony placed the value of the land at $660,000, if it had been in an unimproved condition at the time of purchase. But it must be remembered that petitioner did not purchase the land in an unimproved condition. The land, when petitioner purchased it in 1945, was improved by a building which had been erected by petitioner in a prior year at a cost of $3,000,000, and the land was leased to petitioner for a term of 21 years still to run at an annual rental of $118,840. What petitioner paid Wendel Foundation $2,100,000 for was the bundle of rights which it obtained in the purchase. Included in this bundle of rights was the cancellation of the lease which still had 21 years more to run. Petitioner contends that all above $660,000, which was the value of the land if it had been in an unimproved condition, or $1,440,000, represented the price which it paid for the cancellation of its lease and that this entire [fol. 12] amount of $1,440,000 should be allowed in the tax-

able year 1945 as a deductible business expense under section 23(a) of the Code printed in the margin.[1] Petitioner, in contending that the entire amount of $1,440,000 should be allowed as a deduction for business expense in the taxable year, relies heavily upon *Cleveland Allerton Hotel, Inc.* v. *Commissioner*, 166 F. 2d 805, reversing T. C. Memorandum Opinion. In that case the court of appeals said:

> As purely legalistic formalism, this argumentation bears an aura of validity. Realistically considered, however, it will not stand analysis. The status of the petitioner does not approximate that of a third person investor, buying real estate to which is appurtenant a long-term profitable lease. The petitioner already had the use of the land with full control and dominion over it, subject only to its obligation to surrender it at the end of the term. The lease was a liability which it sought to extinguish. This it was [fol. 13] impossible to do merely by buying acquittance and giving up possession of the premises. It had thereupon a valuable hotel building which it could not take away with it. The only interest in the land it secured

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[1] SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

ly the purchase that it did not already have was the reversionary interest, which all parties appear to consider as of only nominal value. To consider that remainder a capital asset with a value of $441,250 requires, it seems to us, a naivete not attributable to experienced and sophisticated taxing authority. * * *

If numerous admonitions that taxation is a practical matter, that taxing authority may look through form to substance, is not mere rhetoric where the taxpayer's interest is involved, and a working formula only when it is of advantage to the Treasury, it would seem to be clear that the petitioner paid all over $200,000 to escape from a burdensome lease, and should be able to write that off as an expense of doing business.

We are unable to agree with the learned court that in a case like the *Cleveland Allerton Hotel* case or the one which we have here, the taxpayer should be allowed to deduct as a business expense in the year when paid that part of its payment which it claims should be allocated to the cancellation of a burdensome lease. The court in holding that the amount which the taxpayer claimed should be allocated to the cancellation of the burdensome lease and should be allowed as a deductible business expense in one year said:

This being so, we find ourselves in accord with the decision of the Third Circuit in Cassatt v. Commissioner, 3 Cir., 137 F. 2d 745 and with the decision of the Board of Tax Appeals in Appeal of Denholm & McKay Co., 2 B. T. A. 444, that payments of this char- [fol. 14] acter must be deducted on the taxpayer's tax return as an expense of doing business in the year when made. * * *

We think *Cassatt* v. *Commissioner*, 137 F. 2d 745, affirming 47 B. T. A. 400, and *Denholm & McKay Co.*, 2 B. T. A. 444, are distinguishable. In *Denholm & McKay Co.*, the taxpayer did not own the building which it was renting. Both building and land were owned by the Denholm & McKay Realty Co. and what the taxpayer purchased from

the Realty Co. was a complete cancellation of the lease and a surrender of possession under that particular lease and the securing of a new lease of the same building under much more favorable terms than the old lease. Denholm & McKay did not acquire title to the land from the Realty Co. In *Cassatt* v. *Commissioner*, *supra*, the court pointed out that:

> In the early part of January, 1935, Cassatt and Company were obligated on several leases of office space for terms not expiring until 1941. The aggregate prospective rentals for these leases was $1,076,000. A settlement was effected with the various landlords whereby, for $346,524.06 the leases were cancelled for the unexpired terms. * * *

Thus, in that case there was not only a cancellation of the leases but a complete surrender of possession thereunder to the landlords.

We have no such case here. As we have already pointed out, petitioner, in making purchase of the cancellation of the lease from Wendel Foundation, had no notion of surrendering possession to the landlord. If it had done so, we would, of course, have an entirely different case from the one we have here. It owned a 22-story steel and concrete building which, according to testimony, had a remaining [fol. 15] useful life of 30 years. What petitioner purchased for $2,100,000 is shown in its contract of purchase dated May 11, 1945, followed by the deed to the property which petitioner received on June 11, 1945. Petitioner purchased a capital asset and we sustain the Commissioner in his determination that no part of the purchase price can be deducted as a business expense in 1945. Cf. *Home Trust Co.* v. *Commissioner*, 65 F. 2d 532.

Claim for Amortization Deduction

Petitioner's first alternative is stated thus in its brief:

> However, in the event the Court should find that the amount paid in excess of the land value to effect a saving in rent expense is a capital asset, petitioner ther

> claims it is entitled to amortize said asset over 21 years, the remaining life of the cancelled lease.

Petitioner does not cite any authority in support of this first alternative contention and we do not know of any. It is, of course, true that if a taxpayer purchases a lease which has, say 21 years to run, and does not purchase the fee his purchase is a wasting asset and the cost of the lease is not deductible in the year of purchase but must be amortized over the life of the lease. See *Home Trust Co. v. Commissioner*, *supra*, and many cases there cited. But here petitioner has not purchased any lease. In the transaction which has been consummated petitioner has obtained title to the land and has secured the cancellation of the lease which, under the circumstances then existing, it regarded as burdensome. It is true, of course, that petitioner in the purchase of land acquired a capital asset but it is not an asset which is subject to depreciation or amortization. Its value may increase from year to year or, on the [fol. 16] other hand, may decrease but gain or loss can be taken only when the land is finally disposed of. But, while it is true that petitioner in the purchase of the land in 1945 acquired a capital asset, we do not think it can be said that petitioner in procuring the cancellation of its burdensome lease acquired a capital asset which it can amortize over the remaining term of the lease. The lease was at an end when petitioner procured its cancellation in 1945. We think petitioner's first alternative contention must be denied.

Additional Depreciation on the Building

Petitioner's second alternative is stated in its brief as follows:

> In the event the Court should find that no part of the payment of $2,100,000 represents an allowable deduction for obtaining a release from a lease agreement, petitioner then contends that $1,500,000 represents the cost of building which it is entitled to depreciate over a remaining life of 30 years.

The following facts with reference to depreciation seem to be undisputed by the parties: The respondent, for the

taxable year, has allowed petitioner depreciation on the building equivalent to petitioner's unrecovered cost because its first 21-year term of the lease ended in 1945. That depreciation deduction is not in dispute here. During this original 21-year term of the lease, including the part of it which expired in 1945, petitioner has recovered tax free through depreciation deductions the entire $3,000,000, cost of erecting its building. Petitioner has claimed, however, on its return for 1945, that it acquired the building in effect for the second time in 1945 and has claimed depreciation on this second cost. This latter amount of depreciation [fol. 17] the Commissioner has disallowed and has confined his allowance for depreciation deduction petitioner's unrecovered cost of its building. Petitioner having fully recovered the cost of its building by way of depreciation deductions in 1945 and prior years had no unrecovered cost of its building.

We think that the bundle of rights which petitioner acquired by its contract of purchase of May 11, 1945, followed by the deed of June 11, 1945, was so inextricably entwined in the acquiring of the land as not to be separable therefrom. We think that no part of the $2,100,000 which petitioner paid can be allocated to the cost of the building which petitioner already owned and which it had been allowed to fully depreciate over the first 21-year term of the lease. The building and the lease were not bargained for or purchased separately. They were included, in so far as the lessor had any interest therein, in the single transaction of the contract of purchase of the land and the deed to petitioner thereof. If petitioner were allowed additional depreciation deductions for the building which it claims in its second alternative, it would then have depreciated the building once since it has been erected and paid for by petitioner and a second time because it has purchased the land under the building. Petitioner cites no case which would support such a deduction and we know of none. Petitioner's second alternative is denied.

The only other issue which remains for our decision was stated in petitioner's brief as follows: "Is petitioner entitled to deduct that part of the $16,500.00 legal expenses incurred to acquire the fee and to cancel a burdensome

lease?" The Commissioner in his disallowance of this deduction stated in his deficiency notice: "Deduction of legal expenses, in the amount of $16,500.00, incurred in connection with the acquisition of your property has been disallowed because it represents a capital expense." We think the Commissioner must be sustained in the disallowance of this claimed deduction. It was made to obtain [fol. 18] capital assets and, as such, did not represent a deductible expense.

Reviewed by the Court.

Decision will be entered under Rule 50.

Withey, J., concurs in the result.

ARUNDELL, MURDOCK, OPPER, TIETJENS, RAUM and RICE, JJ., dissenting:

Some part of the purchase price should be allocated to the additional rights in the building acquired in the purchase, using the principle of *Cohan* v. *Commissioner*, 39 F. 2d 540, if necessary. This additional cost of the building would then be recovered through depreciation.

[fol. 19] THE TAX COURT OF THE UNITED STATES

Washington

Docket No. 36321

MILLINERY CENTER BUILDING CORP., (now Fashion Center Building Corp.), Petitioner;

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION—Entered March 22, 1954

Pursuant to the Findings of Fact and Opinion of the Court promulgated February 26, 1954, the parties on March

22, 1954, having filed an agreed computation of the tax, now therefore, it is

Ordered and Decided: That there is a deficiency in excess profits tax for the taxable year 1945 in the amount of $39,465.62.

(Signed) Eugene Black, Judge.

Enter:

Entered Mar. 22, 1954.

[fol. 20] UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Argued March 15, 1955

MILLINERY CENTER BUILDING CORPORATION, Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

OPINION—April 14, 1955

Before Clark, Chief Judge, Frank, Circuit Judge, and Galston, District Judge

Petition to review a decision of the Tax Court of the United States, Eugene Black, Judge.

Petitioner, Millinery Center Building Corporation, seeks review of a decision, 21 T.C. 817, finding a deficiency in its excess profits tax for 1945, based on disallowance of deduction, depreciation, or amortization of sums expended in cancellation of a lease through acquisition of, and merger with, the underlying fee. Reversed and remanded.

Charles Korn, New York City (Bernard Weiss, New York City, on the brief), for petitioner.

Carolyn R. Just, Sp. Asst. to Atty. Gen., Washington, D. C. (H. Brian Holland, Asst. Atty. Gen., and Ellis N. Slack, A. F. Prescott, and Louise Foster, Sp. Assts. to Atty. Gen., Washington, D. C., on the brief), for respondent.

CLARK, Chief Judge:

This petition for review contests the finding of a deficiency in petitioner's excess profits tax for 1945, based on the refusal to allow as a business expense the amount paid [fol. 21] to terminate an allegedly burdensome lease. The issue concerns the tax consequences of a contract between the taxpayer and its landlord whereby the taxpayer acquired the real estate in question and thus obtained cancellation of the lease. The taxpayer as tenant and at its own cost had erected a 22-story loft building on the leased premises, to belong to the taxpayer only as long as the lease was in force and at termination to be either razed or surrendered to the landlord, as the latter might direct. The lease had been renewed by the tenant for an additional 21-year term just before the contract of sale was entered into, although the tenant now urges that the annual rental of $118,840 was excessive, notwithstanding the very substantial rents it was collecting, sufficient at least to make the renewal desirable. Petitioner's main argument throughout this litigation has been that the difference between the purchase price of $2,100,000 and the unimproved value of the land, $660,000, namely the sum of $1,440,000, should be deductible as an ordinary business expense under I.R.C. § 23(a) as the price of cancellation of an onerous lease. Alternatively it suggested amortization of this amount over the unexpired term of the lease, or its depreciation as an additional cost of acquiring the already fully depreciated building. All this the Tax Court denied, although six judges dissenting thought that some part of the purchase price should be allocated to the additional rights thus acquired in the building and then be recovered through depreciation. 21 T.C. 817.

The Tax Court refused to permit deduction under I.R.C. § 23(a) because it considered the $2,100,000 contract price as payment for one complete bundle of rights of land ownership, more appropriately characterized as a capital asset than as an ordinary business expense. With this conclusion we are in agreement, despite the contrary opinion [fol. 22] of the Sixth Circuit in *Cleveland Allerton Hotel*

v. *C.I.R.*, 6 Cir., 166 F. 2d 805.[1] Whatever may be the case where a lease is cancelled without the purchase of a fee, we think that the situation here at hand consists of the acquisition of a definite and substantial property interest, so to be viewed for tax purposes. Petitioner, having certain rights in the property, bought all the remaining ones up to full ownership and is in the same situation as if it had bought out the share of a co-owner or an overriding easement or, indeed, a piece of land next door. Because petitioner also happened to be the tenant under the lease, its purchase resulted in the merger of the leasehold in the fee and gave it a good bargain. But that fact, while it may explain the motivation for the investment, cannot change its fundamental nature from the acquisition of a capital asset to mere removal of a burden or repair of plant. *Post* v. *C.I.R.*, 2 Cir., 109 F. 2d 135; *Herzberg* v. *Alexander*, D.C.W.D. Okla., 5 F. Supp. 334; *Boos* v. *C.I.R.*, 30 B.T.A. 882; and see *Willcuts* v. *Minnesota Tribune Co.*, 8 Cir., 103 F. 2d 947, 952, certiorari denied *Minnesota Tribune Co.* v. *Willcuts*, 308 U.S. 577. We reach this result whether or not the lease was in fact onerous to the taxpayer, as it contends; the Tax Court made no such finding and the evidence in this respect is doubtful at best. But that merely goes to the desirability or otherwise of the bargain; it does not define what was bought. We are equally in accord with the Tax Court that the purchase price of the fee is not to be amortized over the remaining term of the now nonexistent [fol. 23] lease. Since the taxpayer has acquired the complete title to the property in question, it obviously no longer has a wasting asset to come to a necessary end twenty-one years hence. See *Post* v. *C.I.R.*, *supra*, 2 Cir., 109 F. 2d 135; *Friend* v. *C.I.R.*, 7 Cir., 119 F. 2d 959, certiorari denied 314 U. S. 673. But we do think the view of

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[1] This case is criticized in Notes, 48 Col. L. Rev. 967 and 1 Stan. L. Rev. 147. Both notes suggest that the court erred in considering the investment to be other than a capital asset. Both equally reject the solution of the Tax Court in that case and this one that no depreciation whatever be allowed, suggesting as an alternative amortization over the remaining term of the lease.

the dissenting judges sound that here is a new purchase price covering a building to be recovered taxwise, as is any building cost, over the period of its useful life.

The taxpayer's second alternative raised this issue in arguing that $1,440,000 be added for depreciation purposes to the cost of the building which it erected on the property. The cost of $3,000,000 originally invested by it in the building was fully written off during the first 21-year term of the lease. From this, a majority of the Tax Court concluded that no further depreciation was allowable, since the taxpayer's cost of acquisition had been recovered. But the dissent seems more in accord with the realities of this situation. The taxpayer in acquiring this fee bought not only a reversionary interest in the land itself, but also a reversionary interest in the building which under the lease it would have had to surrender to the landlord when its term expired. A third-party purchaser of such a fee would be entitled to allocate part of its cost to the building and to depreciate it as such. Similarly, this taxpayer has made an additional investment in the building which should give rise to an added depreciation deduction in accordance with I.R.C. § 23(1).

On the present state of the record we cannot determine how much of the $2,100,000 purchase price is properly to be allocated to the land and how much to the building. The Tax Court has found only that in its unimproved state the land was worth $660,000. That appraisal cannot be con-
[fol. 24] sidered as conclusive of its present value, improved by a $3,000,000 building appurtenant thereto. We doubt if a merely mechanical apportionment will adequately fix the intrinsic value of the building reversion. Hence we must remand this case to the Tax Court to take evidence, if desired, and otherwise to fix this value. See *Cohan* v. *C.I.R.*, 2 Cir., 39 F. 2d 540, 543, 544. A similar adjustment should be made with respect to the legal fees of $16,500 incurred by the taxpayer in connection with this purchase. The value so found will be the cost to be recovered through yearly depreciation.

Reversed and remanded for further proceedings in accordance with this opinion.

[fol. 25] UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MILLINERY CENTER BUILDING CORP., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

JUDGMENT—April 14, 1955

Appeal from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is reversed and action remanded for further proceedings in accordance with the opinion of this Court.

It is further ordered that a Mandate issue to the said The Tax Court of the United States in accordance with this decree.

(S.) A. Daniel Fusaro, Clerk.

[fol. 26] UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

[Title omitted]

PETITION FOR REHEARING—Filed April 28, 1955

To the United States Court of Appeals for the Second Circuit and the Honorable Judges thereof:

The above named petitioner hereby respectfully petitions for a rehearing which the Court has inherent power to grant to prevent injustice, pursuant to Rule 25 of the Court's Rules and in support thereof shows:

The Court's opinion in this proceeding, filed April 14, 1955, holds (P. 1056-1057) that a payment made to obtain

the cancellation of a lease at the same time the land is purchased is not an allowable deduction under Section 23(a) of the Internal Revenue Code of 1939. While this conclusion may be proper in many instances, such as in *Herzberg v. Alexander*, 5 F. Supp. 334 and *Boos v. Commissioner of Internal Revenue*, 30 B.T.A. 882, it is not applicable to the facts in this proceeding.

Petitioner claims that the opinion of the Court does not consider the argument upon which the petitioner places [fol. 27] great reliance and which may not have been adequately stressed in the original argument before this Honorable Court.

The decision of this Court, denying the deduction of $1,440,000, was based on the theory that the taxpayer had paid $2,100,000 for a "complete bundle of rights of land ownership" and the situation was the same "as if it had bought out the share of a co-owner or an overriding easement or, indeed, a piece of land next door." Such conclusion failed to give consideration to a basic tax principle not sufficiently stressed in the argument advanced to the Court that payments must be considered in accordance with the purpose for which paid in determining the tax consequences to the taxpayer.

Thus, in *Western Wine & Liquor Co. v. Commissioner*, 18 T.C. 1090, a wholesale liquor dealer purchased some shares of American Distilling Co., which was offering its shareholders the right to purchase whiskey inventory at cost. After exercising these rights, the taxpayer sold the stock at a loss. The Tax Court, emphasizing that the taxpayer purchased the distilling stock not as an investment in stock but only to acquire more whiskey to replenish its inventories in order to sustain its business, held that the difference between the cost of the American Distilling stock and the selling price represented additional cost of the whiskey acquired. Certainly the vendor of the American Distilling stock to the taxpayer was selling his entire interest in the stock and all the rights that accrued therein but the Tax Court did not bottom its decision on such fact but on the intent of the vendee-taxpayer. This decision was appealed by the Government to the U. S. Court of Appeals, Eighth Circuit, but the appeal was dismissed. 205 F. 2d 420.

inherent therein was to acquire the assets and the amount paid for the stock was allocated to the real estate and other assets. Under this category would be the leading cases of *Prairie Oil & Gas Co. v. Motter*, 66 F. 2d 307; *Commissioner v. Ashland Oil & Refining Co.*, 99 F. 2d 588; certiorari denied, 306 U.S. 661; *Kopper Coal Co.*, 6 T. C. 1209.

Farm land or orchard land is often bought and sold with the crop thereon for a single amount but allocations have been recognized by the Commissioner and, where not, certainly by the Courts.

With regard to the principle of merger, the decision of *Laird Bell v. Carter H. Harrison*, 212 F. 2d 253, is applicable. In that case a trust remainderman purchased the life interest of his parents and amortized the cost of the life estates over the life expectancy of his parents. The Commissioner disallowed the deduction for amortization, contending there was a merger of the two estates, particularly in view of the fact that the plaintiff evidenced no intent to preserve the two interests separate and distinct, and that in view of this merger the capital invested could be recouped only at the time of sale or other disposition by way of being added to the cost basis of such property. The Court of Appeals (Seventh Circuit), sustaining the taxpayer, dismissed this argument of merger or "bundle of rights".

The decisions referred to by the Court, *Post v. Commissioner*, 109 F. 2d 135; *Herzberg v. Alexander*, D. C. W. D. [fol. 30] Okla. 5 F. Supp. 334; and *Boos v. Commissioner*, 30 B. T. A. 882, are not in point in that each pertains either to a taxpayer who was already a fee owner or a taxpayer who had acquired the lease interest as an investment; whereas in the instant proceeding the Millinery Center Building Corp. already owned the building, had a lease on the land, enjoyed the income therefrom and did not have to make any current payment to acquire an investment in the lease.

In *Post v. Commissioner*, *supra*, the taxpayer was the owner of the land, who at the same time had a leasehold interest arising from the tenant's destruction of an old building on his property in order to put up a new one. A few years later, the tenant's interest was sold on foreclosure sale to a new company, all of whose stock and securities

were received by the landlord, the landlord transferring his fee property to the new corporation. Here the landlord had not paid any amount to anyone and the accounting item of leasehold was merely transferred to the new company in exchange for the stock. There was no actual loss to deduct.

In *Herzberg* v. *Alexander*, *supra*, the taxpayer had purchased an unexpired lease for 8 years and 9 months of an original 10-year lease from the tenant for $5,000. In the next year the taxpayer purchased the land and building from the owners for a consideration of $63,500. Where a taxpayer pays the lessee a sum of money to take over a lease, it is obvious that the lease is not onerous but favorable to the tenant and less favorable to the landlord. Then, the property sold subject to a lease not favorable to a landlord would probably command less than the actual value of the land and building and the addition of the lease payment to the property cost would tend to compensate for this fact and give the fair market value.

To illustrate: property is leased at $10,000 per annum for a period of 20 years but after 5 years the rental value [fol. 31] of the property increases to $20,000 per annum. Because of the favorable low rent of $10,000 per annum, the tenant could sell his leasehold interest for $50,000. The landlord, however, subject to the low rent of $10,000 instead of the fair rental value of $20,000 finds that based on land values surrounding his property, his land should be worth $300,000; but he can only receive $200,000 because of the unfavorable lease. Now, if the new lessee, who has paid $50,000 to acquire the leasehold interest, purchases the land for $200,000, it would obviously be unjust and improper to allow him to write off that $50,000. That $50,000 is more properly added to the $200,000 purchase price to arrive at the actual value of the property purchased.

That is not the case in the instant proceeding where the tenant pays a sum of money to save paying excessive rent as well as being relieved from other onerous lease terms and where proof has been submitted that the actual value of the land is much less than $2,100,000.

In *Boos* v. *Commissioner*, *supra*, the taxpayer in 1927 acquired, at a cost of $25,000, a 99-year lease with option to purchase, and in the very next year exercised the option

and acquired the remainder interest. The facts in Boos indicate that the entire transaction can be considered one continuing transaction, making the taxpayer's cost the initial $25,000 and the $55,000 paid in the next year. Furthermore, when a taxpayer pays $25,000 to acquire a lease, it cannot very well argue that the lease was onerous and that the purchase of the property was to effect the cancellation of the lease.

In answer to the obvious question, why did the Millinery Center Building Corporation renew the lease in April 1945, it is respectfully submitted to the Court that the petitioner had a building thereon of substantial value, with a remaining [fol. 32] economic life of 30 years and assessed in excess of $2,100,000, which investment it desired to retain.

This Court raised the question of whether the lease was in fact onerous, although such fact or lack thereof was not determinative of the Court's decision. Petitioner respectfully points out that the Tax Court did find that "petitioner purchased the fee to be released from the terms of the lease. Petitioner was most concerned about the annual rental of $118,840, which it deemed excessive, and the contingent liability to remove the building from the premises at the expiration of the lease upon the request of the landlord." (A 8)

There was also undisputed expert and authoritative testimony that the fair rental value of the land was between $35,000 and $40,000 per annum in 1945, although the petitioner was paying $118,840. (R. 148, 168, 170).

It is not necessary to lose money for a lease to be onerous. When one is paying 2½ times the fair rental value, that in itself affords a basis for the taxpayer to pay a sum to cancel such a contract. (See *The Stuart Co. v. Commissioner*, Tax Court Memo. Opinion Docket 12413, Aff'd 195 F. 2d 176).

The Post, Herzberg and Boos cases may be further distinguished from the instant proceeding in that the principle expressed therein pertaining to minor interests becoming merged with major interests is not applicable here. According to the testimony at the Tax Court trial, the fair rental value for the land alone on which the Millinery Center Building was erected was between $35,000 and $40,000

per annum compared to the $118,840 being paid. The excess of rent to be paid for the next 21-years would be more than $1,600,000. To save this very substantial amount, and further substantial amounts in the event the lease was renewed, the taxpayer bought a piece of land worth $660,000. The purpose of this transaction was the saving of at [fol. 33] least $1,600,000 in rent and not the acquisition of a piece of land worth $660,000, which the taxpayer did not have to acquire in the first instance to enjoy the continued use of the premises. The purchase of the land was only incidental to and the only means by which the taxpayer could cancel an onerous lease and still retain its equity in the building which was productive of income. The transaction was not primarily to acquire land which only secondarily and incidentally resulted in the cancellation of the lease.

The result of this Court's opinion may be demonstrated in the following illustration. Assume a third party, desiring to make an investment, buys land and building for $2,100,000. The purchaser would make an allocation between land and building and depreciate the building over the period of useful life. Now suppose the building was erected by a tenant who has a leasehold running for 42-years. The purchaser would then be buying land and leasehold, which leasehold would be amortizable over the 42-year period, in accordance with decision of *Mary Young Moore* v. *Commissioner*, 207 F. 2d 265. Now, assume that the tenant of the leasehold wishes to do what the third party did and purchase the property for $2,100,000. Since he already has the lease he will not be acquiring a leasehold and since the lease is for a longer period of time than the life of the building, he may not be acquiring a reversionary interest in the building and therefore must be paying $2,100,000 for the land alone, even though the land is only worth $660,000. Following this argument further, the land, which is only worth $660,000 when an outsider buys it for an investment, suddenly becomes worth $2,100,000 when the leasehold tenant acquires it.

This Court, in its opinion, inferred that the value to be attributed to the land might be more than the $660,000 found by the Tax Court for the land unimproved. This [fol. 34] Court stated: "That appraisal cannot be consid-

cred as conclusive of its (land) present value, improved by a $3,000,000 building appurtenant thereto."

Petitioner respectfully points out that any value attributed to the land because of a building erected thereon makes the land a wasting asset, which is not contemplated by the Internal Revenue Code. There is no question that the building will eventually be of no economic value and therefore the land some day will be worth only the value of the land without any offsetting value for a building. To attribute an increased value to the land because of such a condition and not permit depreciation thereon means a taxpayer has a wasting asset, concurrent with the depreciation of the building which is not going to be recovered taxwise. This is contrary to every accounting principle and to the very meaning of Section 23 (l) of the Internal Revenue Code of 1939 and the Regulations promulgated thereunder.

In *Commissioner* v. *Stary Brothers*, 204 F. 2d 673, this Court held that an amount received by a dealer from a drug manufacturer in exchange for releasing the manufacturer from its contract obligation not to sell other dealers was ordinary income and did not constitute the sale of a capital asset. The Court agreed the taxpayer's rights were undoubtedly property but held the *termination of a contract is not a sale or exchange.* The property rights were not transferred, they merely came to an end and vanished. This case applied to the Millinery Center Building Corporation proceeding makes the answer clear—there were no property rights acquired by the Millinery Center Building Corporation in the cancellation of the lease. Whatever property rights to the excessive rent existed were not transferred as if to a third party purchaser but "merely came to an end and vanished." There was no "bundle of [fol. 35] of rights" to the Millinery Center Building Corporation and the amount paid to secure such vanishment was an ordinary and necessary expense and an allowable deduction.

It is stressed before the Court that the deduction of $1,409,000 or any part thereof does not result in a net tax loss to the Treasury but only compensates in part for the additional tax that is going to be paid by the petitioner in each year for at least the next 21 years. The petitioner's

returns for 1945 and ensuing years no longer reflect the deduction of rent expense of $118,840. Its land investment entitles it to a saving in rent from $35,000 to $40,000 per annum, but the balance of approximately $80,000 the taxpayer is saving because it incurred the expense of $1,440,000, and it is paying tax on such $80,000 each and every year without any offsetting deduction, and at the end of 30 years it will have a land asset of only $660,000. This is an unconscionable deprivation of capital of this taxpayer.

Petitioner therefore respectfully requests a rehearing upon these points at the Court's convenience. Should further oral argument be deemed impractical, petitioner requests that consideration be given to the points set forth herein.

Respectfully submitted, Bernard Weiss, Counsel for Petitioner on Review, 136 East 57th Street, New York 22, N. Y.

April , 1955.

[fol. 36] CERTIFICATE OF COUNSEL

I, Bernard Weiss, do hereby certify that I am Counsel of Record for petitioner on review in the above entitled proceeding; that the foregoing petition for rehearing is presented in good faith and not for the purpose of delay or vexation, and that in my opinion it is well founded in law and fact and proper to be presented to the Court.

Bernard Weiss, Counsel for Petitioner on Review.

[fol. 37] UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

[Title omitted]

RULING ON PETITION FOR REHEARING — May 18, 1955

PER CURIAM:

Petition for rehearing denied.

C. E. C., J. N. E., U. S. C. J.J.; C. C. G., U. S. D. J.

[fol. 38] UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

[Title omitted]

ORDER DENYING PETITION FOR REHEARING—May 18, 1955

A petition for a rehearing having been filed herein by counsel for the petitioner,

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

(S.) A. Daniel Fusaro, Clerk.

[fol. 39] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 39A] SUPREME COURT OF THE UNITED STATES

[Title omitted]

ORDER ALLOWING CERTIORARI—Filed October 10, 1955

The petition for writ of certiorari to the United States Court of Appeals for the Second Circuit is granted limited to questions 1 and 2 presented by the petition for the writ which read as follows:

"1. Where a lessee, the owner of a valuable building on leased land, acquires the fee to the land to be relieved of what it considers to be the burdensome terms of a lease, may the lessee deduct the excess of the payment over the determined value of the land at the date of purchase as an ordinary expense of doing business under § 23(a) of the United States Internal Revenue Code of 1939 or under 23(f) as a loss on a transaction entered into for profit and not compensated for by insurance or otherwise.

"2. In the alternative, may the lessee-petitioner consider the excess payment over the determined value of the land to be in the nature of a prepayment of rent

for the remaining term of the extinguished lease and amortize such amount over 21 years."

The case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

[fol. 40] BEFORE THE TAX COURT OF THE UNITED STATES

EXHIBIT 3-C

This Agreement made the 11th day of May, 1945, between Wendel Foundation, a New York corporation, party of the first part, hereinafter designated as the Seller; and Millinery Center Building Corporation, a New York corporation, having its principal office at No. 525 Seventh Avenue, Borough of Manhattan, City of New York, party of the second part, hereinafter designated as the Purchaser;

Witnesseth that the Seller agrees to sell and convey and the Purchaser agrees to purchase:

All those certain lots, pieces or parcels of ground, situated in the Borough of Manhattan of the City and State of New York which taken together are bounded and described as follows:

Beginning at a point formed by the intersection of the Northerly line of Thirty Eighth Street with the Easterly line of Seventh Avenue; running thence Easterly along the Northerly line of Thirty eighth Street, Two Hundred feet (200'); running thence Northerly at right angles with Thirty Eighth Street, Ninety Eight Feet and Nine inches (98' 9") to the center line of the block between Thirty Eighth Street and Thirty Ninth Street; running thence Westerly along said center line of the block Two Hundred feet (200') to the Easterly side of Seventh Avenue; running thence Southerly along the Easterly side of Seventh Avenue Ninety Eight feet and nine inches (98' 9") to the point or place of beginning.

[fol. 41] Being the same premises described in lease dated April 30, 1924 by Rebecca A. D. Wendel Swope and Ella V. Von E. Wendel to Millinery Center Building Corporation, recorded in the Register's Office of New York County in Liber 3448 of Conveyances at Page 71.

The price is Two Million One Hundred Thousand Dollars ($2,100,000.) payable as follows: Two Hundred Ten Thousand Dollars ($210,000.) on the signing of this contract, receipt whereof by check subject to collection is hereby acknowledged, the non-payment of which check in due course shall give Seller the option of cancelling this agreement; and the balance, One Million Eight Hundred Ninety Thousand Dollars ($1,890,000.) on the delivery of the deed as hereinafter provided, by certified check satisfactory to the Seller, the check to be drawn to the order of the Seller and payable through the New York Clearing House.

The premises shall be conveyed subject to zoning restrictions; to the right of the City of New York to require the removal or closing up of any coal chutes or vaults under the streets or highways adjoining the premises and to any unpaid permit or vault fees with respect thereto; to encroachments, if any, upon the adjoining streets or highways by windows when open, show windows, terra cotta piers on the third story balcony at the nineteenth story, ledges, cornices, window sills, trim, standpipes, signs, marquees, vault lights and sidewalk elevator doors; to encroachments, if any, upon adjoining properties by exhaust pipes from windows of building on premises to be conveyed and by windows of said building when open; and to any other state of facts that an accurate survey would show.

[fol. 42] The premises shall also be conveyed subject to that certain lease made by Rebecca A. D. Wendel Swope and Ella V. Von E. Wendel to Millinery Center Building Corporation, dated April 30, 1924, and recorded in the Register's office of New York County in Liber 3448 of Conveyances at Page 71 and to all agreements amending, modifying, renewing or extending the same, (with all of which the Purchaser is familiar, being the tenant thereunder), to the rights of sub-tenants, under-tenants and occupants of the premises, to any mortgages, liens or other encum-

brances on the leasehold estate, to mechanic's liens, if any, against the fee or lease hold suffered by the tenant to remain undischarged at the time of the delivery of the deed, to any notes or notices of violation of law or Municipal ordinances, orders or requirements affecting the premises, noted in or issued by any State or Municipal Bureau or Department which shall not have been complied with or removed at the time of the delivery of the deed, to all taxes, assessments, or water charges unpaid at the time of the delivery of the deed, and to any and all other liens, encumbrances or charges upon the fee or leasehold estate for the payment or discharge of which the tenant is responsible under the terms of the aforesaid lease, as modified, amended, extended or renewed by said agreements.

Seller shall execute upon request of Purchaser an agreement cancelling and terminating said lease as of the time of the actual closing of title hereunder. It is agreed, however, that regardless of whether Purchaser accepts title to the premises subject to the afore-mentioned lease or elects to have an agreement cancelling and terminating same, the idemnity [*sic*] agreements of Purchaser con- [fol. 43] tained in the said lease shall continue in full force and effect after closing of title in favor of the Seller with respect to any liabilities or obligations of Seller assumed by or imposed upon it by the terms of the lease or any such agreements of amendment, modification, extension or renewal or arising out of Seller's ownership of the said premises.

The premises shall also be conveyed subject to all laws or regulations now existing or hereafter enacted by the Federal, State or Municipal Governments or authorities regulating or restricting the amount of rent which may be charged for the whole or any part of the premises or the term of occupancy of any tenant or under-tenant, or the services to be rendered to any tenant or under-tenant, or affecting in any other manner the rights or obligations of any landlord or tenant of the premises.

This sale covers all right, title and interest, if any, of the Seller in any land lying in the bed of any street, road or avenue, opened or proposed, in front of or adjoining said premises, to the centre-line thereof, and all right, title and

interest of Seller in and to any award made or to be made in lieu thereof, and in any award for damage to said premises by reason of change of grade of any street; and the Seller will execute and deliver to the Purchaser on closing of title, or thereafter, on demand, all proper instruments for the conveyance of such title and the assignment and collection of any such award.

If any loss or damage to the building on the premises by fire or other cause shall occur and such loss or damage shall not have been replaced, restored or repaired prior to the date of closing title hereunder, the fact that the build- [fol. 44] ing has not been replaced, restored or repaired shall not relieve Purchaser of its obligation to complete this contract in accordance with its terms provided Seller shall, upon closing of title, turn over to Purchaser or assign to the Purchaser all its right and interest in any monies deposited with Seller or over which Seller may have any control (including insurance monies and monies deposited by tenant and surety bonds deposited in lieu of such funds) for the purpose of repairing, restoring or replacing the building, less any part of such funds as may have been lawfully expended in accordance with the terms of said lease.

The deed shall be in proper statutory short form for record in the usual form of a Bargain and Sale deed containing no covenant or warranty and shall be duly executed and acknowledged by Seller at Seller's expense, including the cost of the prescribed United States revenue stamps thereon so as to convey to the Purchaser the fee simple of said premises free from all encumbrances except as herein stated.

The deed shall be delivered on the receipt of said payments at the office of Stewart & Shearer, No. 45 Wall Street, Borough of Manhattan, City of New York, on the 11th day of June, 1945, at ten-thirty o'clock in the forenoon, or at the option of Purchaser, on an earlier business day on five (5) days' written notice to Seller. Rents shall be apportioned as of the date of the delivery of the deed.

This contract and all rights thereunder may be assigned by the Purchaser by proper written and acknowledged assignment delivered to the Seller on the closing of title

provided that written notice thereof with the name and [fol. 45] residence of the assignee be delivered to the attorneys for the Seller not less than five (5) days prior to the delivery of the deed.

The Seller represents that the execution by the Seller of this agreement is not prohibited by the President's Executive Order No. 8389, as amended.

The Purchaser represents that the execution by the Purchaser of this agreement is not prohibited by the President's Executive Order No. 8389, as amended.

If the Seller shall be unable to convey title in accordance with the terms of this agreement the sole obligation of the Seller shall be to refund the Purchaser's down payment and to reimburse the Purchaser for the expense incurred in the examination of title, not exceeding the usual charge of a title company therefor. The Purchaser may, however, accept such title as Seller may be able to convey without reduction of the purchase price or claim for damages and it is agreed that Seller shall not be required to bring any action or proceeding or to incur any expense in order to cure any defects in title, and the acceptance of a deed by the Purchaser shall relieve the Seller of any further obligations to the Purchaser under this contract, except as herein otherwise expressly provided.

All sums paid on account of this contract and the reasonable expense of the examination of title to said premises (not to exceed the usual charge of a title company therefor) are hereby made liens thereon but such liens shall not continue after default by the Purchaser under this contract.

The stipulations aforesaid shall apply to and bind the heirs, legal representatives, successors and assigns of the respective parties.

[fol. 46] In Witness Whereof, the parties hereto have executed this agreement, in duplicate, the day and year first above written.

Wendel Foundation, By: (signed) George L. Shearer, President. Millinery Center Building Corporation, By: (signed) A. Simonson, President.

Before the United States Tax Court

Exhibit 6-F

This Agreement, made June 11th, 1945, between Weidel Foundation, a New York corporation having its principal office at 45 Wall Street, Borough of Manhattan, City, County and State of New York (hereinafter called the "Landlord") and Millinery Center Building Corporation, a New York corporation, having its principal office at 525 Seventh Avenue, Borough of Manhattan, City, County and State of New York, (hereinafter called the "Tenant"), Witnesseth:

Whereas, the predecessors in title of the Landlord by lease dated April 30, 1924, leased to the Tenant for the term of twenty-one (21) years ending April 30, 1945, the land and premises located on the northeast corner of Seventh Avenue and 38th Street, fronting 200 feet on 38th Street and 98 feet 9 inches on Seventh Avenue, Borough of Manhattan, City, County and State of New York, more particularly described in said lease, which lease was recorded in the Register's office in New York County on October 10, 1924, in Liber 3448 of Conveyances, Page 71 [fol. 47]. Whereas, the said lease was modified and amended by agreement dated November 30, 1935, and recorded in said Register's office on October 15, 1936, in Liber 3942 of Conveyances, at Page 80; and

Whereas, the said lease was renewed and extended for a further term of twenty-one (21) years ending April 30, 1966, by an agreement in writing dated April 16, 1945, and recorded in the Register's office on April 18, 1945, in Liber 4349 of Conveyances, Page 596; and

Whereas, the Tenant requested the Landlord to accept a surrender of the demised term and the Landlord agreed to accept such surrender provided this agreement was executed simultaneously with the execution of the formal agreement of surrender, which formal agreement of surrender is being executed and delivered simultaneously herewith;

Now, Therefore, in consideration of the premises and the sum of One Dollar ($1.00) and other good and valuable consideration by each of the parties hereto to the other in hand paid, receipt whereof is hereby acknowledged, the

parties hereto do hereby mutually release one another and their successors and assigns from any and all obligations under said lease and modification agreement and under said agreement of renewal and extension thereof, except that the indemnity agreements of the Tenant contained in said lease shall continue in full force and effect after such surrender in favor of the Landlord with respect to any liabilities or obligations of Landlord assumed by or imposed upon it by the terms of the lease or any agreements of amendment, modification, extension or renewal or arising out of Landlord's ownership of the said premises.

[fol. 48] In Witness Whereof the parties hereto have signed, sealed and delivered this instrument on the date first above written.

Wendel Foundation, By: (signed) George L. Shearer, President.

(Seal of Wendel)

Millinery Center Building Corporation, By: (signed) A. Simonson, President.

[fols. 1-21-36] EXHIBIT 1-A

REBECCA A. D. WENDEL SWOPE,

AND

ELLA V. VON E. WENDEL,

WITH

MILLINERY CENTER BUILDING CORPORATION

LEASE—Dated April 30th, 1924

Affecting Premises on the Northeast Corner of Thirty Eighth Street and Seventh Avenue

[fol. 37] Sixth: That the title to all buildings all alterations and all other improvements and fixtures and to all boilers, machinery, elevators, apparatus, electric and gas

fixtures, equipment, decoration, furnishings, and all personal property used by the Tenant, its successors or assigns, in the maintenance and operation of the said demised premises and all replacements and betterments that shall be erected, made or placed on the demised premises by the Tenant, its successors or assigns, shall be the property of the Tenant, its successors or assigns, but at the expiration of the demised term or other sooner termination thereof, or, if this lease shall be renewed as hereinafter provided, at the expiration of the last term for which the same shall be renewed or other sooner termination thereof, at the option of the Landlords, their heirs, successors or assigns, shall [fols. 38-48] vest in the Landlords, their heirs, successors and assigns forever and become at that time their property free from any and all right, title or interest of the Tenant, its successors or assigns therein.

Seventh: That after the said new buildings on the demised premises have been erected as hereinbefore provided, the same shall not be taken down or removed or be substantially or structurally altered without the written consent of the Landlords, their heirs, successors or assigns, to such alteration, which consent shall not be unreasonably withheld, except that, on the order of proper governmental authority that the Tenant has covenanted for itself, its successors and assigns, to comply with as hereinafter provided, necessary alterations and improvements may be made. The Tenant, for itself, its successors and assigns hereby covenants that all alterations and improvements shall be done in a first-class manner, out of materials and with workmanship in keeping with the quality and class of the building or buildings affected, and to the reasonable satisfaction of the landlords, their heirs, successors or assigns.

[fol. 49] Fourteenth: That in the event of any or all of the building or buildings at any time or times upon the demised premises or part thereof being destroyed or injured by fire or any other cause whether rendered untenantable or unfit for occupancy or not, neither the Tenant, its successors nor its assigns shall have the right at any time or times to quit

any portion thereof, neither shall the Tenant, its successors nor its assigns shall have the right at any time or times to quit or surrender possession of the leasehold property or of any portion thereof, neither shall the Tenant, its successors or assigns thereby be released from any of its or their obligations under this lease, neither shall the rent reserved under this lease thereby cease or be withheld or in any way diminished by reason thereof, and the Tenant, for itself, its successors and assigns hereby waives any rights conferred upon it or them under or by virtue of Section 227 of the Real Property Law in this State, or otherwise, [fol. 50] to quit and surrender possession of the demised premises in such event and shall not thereby relieve itself or themselves of its or their obligations under this lease.

Fifteenth: That in case of the damage or destruction of any building or buildings erected on the demised premises during the term of this lease, or any part thereof (including plate glass) by fire, or otherwise, at any time or times, the Tenant, its successors or assigns, with all reasonable dispatch, subject to delays on account of strikes or other causes beyond the control of the Tenant, its successors or assigns or to its or their inability with due diligence to obtain materials, and at its or their own cost and expense, shall repair, restore, rebuild or replace any such building or buildings or any part thereof (including plate glass), so damaged or destroyed.

(1) In the event of a partial destruction of the building or buildings affected and new plans are not required by law to be filed with or approved by public authority, the said building or buildings shall be repaired, restored and rebuilt by the Tenant, its successors or assigns at its or their own cost and expense in accordance with the plans and specifications originally approved by the Landlords, in a first-class manner in keeping with the quality and class of the building or buildings affected and so as to place the same in as good, usable and tenantable condition as they were required to be by the terms of this lease before such damage, and to the satisfaction of the Landlords, their heirs, successors or assigns, but such approval shall not be unreasonably withheld. But in case such building or buildings cannot legally be so repaired, restored and rebuilt, it

or they shall be repaired, restored and rebuilt by the Tenant, its successors or assigns, in a manner reasonably satisfactory to the Landlords, and the mortgagee if any, on the leasehold estate, their heirs, successors or assigns, or if said parties cannot so agree, then the matter shall be sub-
[fol. 51] mitted to and decided by the arbitrators under Article Fortieth hereof, so that the restored building or buildings shall be at least equal in value and in quality and class to those so damaged.

(2) Or, in the event of the total destruction of such buildings or any of them, the Tenant, its sucessors or assigns shall, at its or their own proper cost and expense with all reasonable dispatch and at least within two years from the time of such destruction, subject to delays on account of strikes or other causes beyond the control of the Tenant, its successors or assigns, or to its or their inability with due diligence to obtain materials, erect a new building or buildings in place thereof (of the same type and order as the building or buildings so destroyed) at least equal in value to the building or buildings so destroyed, but in case such new building or buildings cannot legally be erected, and if the parties, including any mortgagee of the leasehold estate if any there be, cannot agree upon the type and order of the building or buildings to be erected, the matter shall be submitted to and decided by the arbitrators as provided in Article Fortieth hereof, so that the building or buildings so erected shall be at least equal in value and in quality and class to those so destroyed.

(3) In all cases of partial destruction where plans are required by law to be filed with or approved by public authority before restoring, repairing, rebuilding or replacing and in all cases of the erection of a new building or buildings, all such restoring, repairing rebuilding, replacing and erecting shall be done in accordance with plans and specifications approved by the Landlords, their heirs, successors or assigns, after the examination thereof by an architect appointed by the Landlords, their heirs, successors or assigns; a copy of which said plans and specifications authenticated by the respective signatures of the agents or attorneys for the Landlords, their heirs, successors or as-
[fol. 52] signs and an officer of the Tenant or its successors

or assigns shall be filed with the Landlords, their heirs, successors or assigns; that the said improvements and buildings shall be made and erected in accordance with the said plans and specifications, and at all times subject to the inspection and report of said architect and to the approval of the Landlords, their heirs, successors or assigns; that the Tenant or its successors or assigns shall and will pay to the said architect his compensation at the rate and at the times hereinafter specified for such services, and on the default of the Tenant or its successors or assigns in so doing the Landlords, their heirs, successors or assigns may pay the same with such interest as may be due to the architect thereon, and the amount of such payment shall become immediately due from the Tenant or its successors or assigns as further rent under this lease with interest thereon at the rate of six per cent per annum from the date of such payment; and that the Landlords, their heirs, successors or assigns shall have the right, which they hereby reserve for themselves and their agents, to enter upon said demised premises and inspect the work in progress at any time; but the approval or approvals provided for in this paragraph shall in no case be unreasonably withheld. That changes or alterations in or to the building may be made by the Tenant, its successors or assigns, after the Landlords, their heirs, successors or assigns have approved the plans and specifications, only after obtaining the Landlords', their heirs', successors', or assigns' consent in the following manner: The Tenant, its successors or assigns shall prepare and submit to the Landlords, their heirs, successors or assigns, plans and specifications embodying such changes or alterations, and the Landlords, their heirs, successors or assigns shall have thirty days after submission thereof for consideration and if the proposed changes or alterations [fol. 53] are safe and sound from an engineering standpoint and will not materially lessen the value of the building and are in conformity with the requirements then existing for the proper use of the buildings, the Landlords, their heirs, successors or assigns shall then give their written consent to the making of such changes or alterations. In the event the parties cannot agree as to such changes or alterations the question of whether they should

be made shall be submitted to arbitration as provided in Article Fortieth hereof.

(4) But in the event of the total or any partial destruction of the building or buildings on the demised premises or any of them for which there are actually received insurance moneys less than the actual cost of restoration and rebuilding (including as part of such actual cost, architect's fees and superintendent's fees and the cost of fire insurance and usual carrying charges during construction) before beginning the operation of the restoration or rebuilding of such building or buildings, the Tenant, its successors or assigns shall pay to the parties holding such insurance moneys (including the Landlords, their heirs, successors or assigns) an amount which with such insurance moneys shall equal such actual cost of restoration and rebuilding, all of which moneys are to be held and paid out in accordance with the provisions of Article Sixteenth relating to the disposition and disbursement of insurance moneys; but in lieu of making such additional payment the Tenant, its successors or assigns shall have the option to deliver to the Landlords, their heirs, successors or assigns a bond (hereinafter called rebuilding bond) in an amount equal to the actual cost of the new building or buildings (including as part of such actual cost, architects' and superintendents' fees and the cost of fire insurance and usual carrying charges during construction) to replace destroyed buildings and the equipment thereof or to the actual cost of the restoration and rebuilding of a building or buildings damaged to the extent [fols. 54-58] aforesaid, as the case may be, executed by itself or themselves and a surety company or companies, reasonably satisfactory to the Landlords, their heirs, successors or assigns, and in the form reasonably satisfactory to the latter, containing the same guarantee to the Landlords, their heirs, successors or assigns in reference to the building or buildings now being considered and the same provisions as to the reduction of the liability thereon as are provided to be contained in the bond or bonds hereinbefore agreed to be given on the execution of this lease in reference to the original new buildings agreed to be erected by the Tenant, its successors or assigns, with such changes as the nature of the case may require to make said guarantees ap-

propriate to the building or buildings now being considered and to the covenants of the Tenant, for itself and its successors and assigns herein contained in reference thereto.

(5) But, if, in any case of such loss, damage or destruction any insurance company, pursuant to its policy of insurance against the said loss, damage or destruction, shall properly elect to repair, restore, rebuild or replace the building or buildings or parts thereof (including plate glass) lost, damaged or destroyed instead of paying therefor in money, it is hereby mutually agreed that the Tenant, its successors and assigns shall not be required to repair, restore, replace and rebuild so much of such building or buildings or parts thereof (including plate glass) as shall have been repaired, restored, replaced or rebuilt by such insurance company.

[fol. 59] Eighteenth: That neither the Tenant, nor its successors nor assigns shall at any time or times hereafter during the term hereby granted, lease, let or demise the said premises as a whole, or assign, transfer or make over this present lease or any of said term therein demised to any person, persons or corporation without the written consent of the Landlords, their heirs, successors or assigns, to each and every proposed assignment or transfer, but such consent shall not be unreasonably withheld; but nothing herein contained shall apply to an assignment pursuant to a sale in foreclosure of a mortgage of the leasehold estate, nor prevent the Tenant, its successors or assigns from subletting without such consent, provided no such sub-lease covers the entire premises. The right conferred by this Article to assign the lease or leasehold estate or to sublet is a continuing right which shall not be exhausted by any one such assignment or subletting, but which shall inure to the [fols. 60-62] benefit of each successive assignee, including a purchaser at a foreclosure sale, during the term of said lease or any renewals thereof, subject, however, to all the covenants and conditions of this lease, which shall be assumed by every assignee, and provided notice of such assignment shall have been given to the Landlords, their heirs, successors and assigns, in the manner and of the substance and form hereinafter provided.

[fol. 63] Twenty-fourth: That the Tenant, its successors and assigns shall and will, at the expiration of this lease or

other sooner termination thereof, or, if this lease shall be renewed as hereinafter provided, at the expiration of the last term for which the same shall be renewed, or other sooner termination thereof, well and truly surrender and deliver up the premises hereby demised, including at the option of the Landlords, their heirs, successors and assigns, the buildings and improvements thereon, free and clear of incumbrances, into the possession of the Landlords, their heirs, successors or assigns without fraud or delay; and the Tenant hereby expressly covenants and agrees for itself, its successors and assigns that the property so surrendered shall at the option of the Landlord, their heirs, successors and assigns, include all new buildings, structures, improvements and the appurtenances and fixtures, and also at such option all boilers, machinery, elevators, apparatus, electric and gas fixtures, equipment and all personal property used [fo. 64] in the maintenance and operation of the said demised premises and all replacements and betterments erected, made or placed upon the demised premises by the Tenant, its successors or assigns during the term of this lease or any renewal thereof, it being expressly understood and agreed by and between the parties hereto that all buildings, improvements, appurtenances, fixtures, and property above enumerated at the expiration of the term of this lease or other sooner termination thereof, or if this lease shall be renewed as hereinafter provided, at the expiration of the last term for which the same shall be renewed, or other sooner termination thereof, shall become, be and remain at their option the property of the Landlords, their heirs, successors and assigns and that neither the Landlords, nor their heirs, nor their successors, nor their assigns are or shall ever be obligated to pay any sum of money whatever to the Tenant, its successors or assigns for, or on account of said property, or any of it.

Provided, however, and this lease is upon the express condition and the tenant expressly covenants and agrees that if the Tenant, its successors or assigns, shall make default in the payment of any instalment or instalments of the rent hereby reserved or of any other sum provided to be paid under this lease on any day upon which the same ought to be paid, and if such default shall continue for sixty days and the Tenant, its successors or assigns, shall have had

thirty days notice of such default given either before or after the expiration of said sixty days or if the Tenant, its successors or assigns shall execute, do, commit, permit or suffer any deed, act, matter or thing contrary to any covenant or agreement on its or their part herein contained or shall fail in the performance of any of either of the covenants, conditions or provisos in these presents contained which on the part or behalf of the said Tenant, its successors or assigns, are or ought to be observed, performed, fulfilled [fols. 65-106] or kept and if such default, defect, failure, deed, act, matter, thing, event or situation complained of shall continue for sixty days and the Tenant, its successors or assigns shall not make good and remedy the same within thirty days after written notice from the Landlords, their heirs, successors or assigns, specifying the matter complained of, given either before or after the expiration of said sixty days (except that in case of default in the completion of the building and improvements provided for in Article Fourth of this lease if the Tenant, its successors or assigns, shall not make good and remedy the same within two years after written notice of such default from the Landlords, their heirs, successors or assigns), then in each of said cases it shall and may be lawful for the Landlords, their heirs, successors and assigns, at their election into and upon the said demised premises or property or any part thereof in the name of the whole to re-enter and repossess (by summary proceedings or otherwise) and to remove any persons therefrom and the same to have, hold and enjoy again as and of their first estate and interest therein and thereupon and from thenceforth this lease and the estate hereby granted (except for the remaining liability of the Tenant, its successors and assigns) shall cease and determine and the violation of or failure to observe any covenant or condition with respect to any portion of the premises hereby demised shall entitle the Landlords, their heirs, successors and assigns at their election to re-enter upon the entire premises subject, however, to the same conditions as to delay and notice appropriate to the particular violation or failure as hereinbefore in this Article set forth.

[Vols. 167-115] Official Report of Proceedings before The Tax Court of The United States

Docket No. 36321

Millinery Center Building Corp. (now Fashion Center Building Corp.), Petitioner

vs.

Commissioner of Internal Revenue, Respondent

Hearing at New York, New York

Date, May 5, 1952

Pages 1-98

[Vol. 116] Abraham Simonson was called as a witness on behalf of the Petitioner, and having been first duly sworn, was examined and testified as follows:

[Vol. 117] Direct examination.

By Mr. Weiss:

Q. In the year 1945 what position did you hold in the Millinery Center Building Corporation?

A. I was president.

Q. In that capacity did you negotiate for the purchase of the fee upon which the Millinery Center Building was located?

A. I did.

Q. In April 1945 did the Millinery Center Building Corporation renew its ground lease with the Wended Foundation for a period of 21 years?

A. We did.

Q. Did your corporation have an option to renew for a further period of 21 years, beginning May 1, 1966?

A. Yes.

Q. Since you had just renewed this lease for 21 years and had the use or possession of the land and building for at least that long and you had an option to renew for an additional 21 years, what motivated your purchasing the fee?

A. I considered—we considered, rather, that—I use round figures—$119,000 instead of 118 something. Is that all right with your Honor?

The Court: Yes.

The Witness: We considered $119,000 a year in rental [fols. 118-125] based on the land value there in 1944 as being very excessive, and besides we had a real serious contingent liability.

By Mr. Weiss:

Q. Will you please explain what you mean by the contingent liability?

A. Well, there was a building there that at the end of the term of the lease we could be asked to remove, and to remove that sort of a building did not mean pennies. It meant a good deal of money. Then under the lease to pay $119,000 for 21 years besides real estate taxes and maintenance, et cetera, we saw a chance of saving a good deal of money. Practically the same land opposite to us on the corner of South—the Southeast corner of 7th Avenue and 38th Street was sold for $600,000. And a rent of $119,000 for our size plot compared with the plot across the street was very excessive.

And of course we always thought of the liability of taking off that building, which meant something to us.

Q. In valuing this land, you said that it had a value of roughly $600,000. What factors do you base this estimate on?

A. As a matter of fact, that land sold for $600,000 in 1944.

Q. You are talking about the property immediately across the street from yours?

A. Right across the street from us, opposite to us.

[fol. 126] The Witness: The $1,500,000 we had to pay there for this thing in itself could mean a big savings because a rental—our rental for 21 years would run to two and one half million dollars. You figure that difference on this renewal and then we had another renewal of 21 years which would figure another two and one half million dollars. To my mind that was a terrific saving as far as rent.

We always considered this building that was on it, that if we ever had to leave and were asked to take it off, it was a

liability that would cost lots of money if they wanted the ground restored to its original condition.

By Mr. Weiss:

Q. For what purpose is the Millinery Center Building being used by its tenants?

A. We have stores and lofts.

Q. What is the type of construction of the Millinery Center Building?

A. Steel, concrete and brick.

Q. How high is the Millinery Center Building?

A. We have the stores, have 21 floors of lofts, and we have a penthouse atop of the building.

Q. Since you considered that the annual net rental of $118,000 was excessive, why did you renew the lease in April of 1945?

A. Well, that is simple. We had an investment there of [fols. 127-142] $3,000,000. We could not take that building off that land and carry it away with us.

[fol. 143] Whereupon, DAVID A. HARRIS was called as a witness on behalf of the Petitioner, and having been first duly sworn, was examined and testified as follows:

Direct examination.

By Mr. Weiss:

Q. What is your full name?

A. David A. Harris.

Q. What is your occupation?

A. Real estate broker.

Q. What is the nature of the business you are engaged in?

A. I am a senior partner of Harris, Newmark & Company, which is a management and leasing business. And I am vice-president of Lefcourt Realty, which owns about [5,000,000 in real estate, and president of the 515 Seventh Avenue Corporation; and I am officer of a lot of other corporations which are not necessary to stipulate here.

Q. These other properties that you were talking about, are they located somewhere in the vicinity of the taxpayer's building?

A. A great number of them, yes.

Q. In March 1944 did you in association with others pur-
[fol. 144] chase a property located at the southeast corner of 38th Street and 7th Avenue?

A. Yes. I bought that with Mr. W. I. Timken of Timken Roller Bearings.

Q. What was the price you paid for it?

A. 600.

Q. 600,000?

A. $600,000, yes.

Q. Will you describe the property, please?

A. Yes. It was 100—well, it is 98.9 on 7th Avenue by 200 on the 38th Street.

Q. Did that property have any structure on it at the time?

A. Yes, it had some old beaten up shanties which had never been improved and a lumber yard.

Q. Now, what is the physical relationship of this piece of property that you are testifying to that you purchased, with respect to the property of the petitioner in this case?

A. Immediately across the street. Just south of it.

Q. And from whom did you purchase this property?

A. The Wendel Foundation.

Q. That is the same party that sold the petitioner their property, is that right?

A. That is right.

Q. Did you offer your property, that is the plot on the
[fol. 145] southeast corner of 38th Street, for sale in the year 1945?

A. Yes.

Q. What was the price at which you offered this property?

A. We were willing to take a little loss, and the reason for that was that the government restrictions were so tight we could not do anything with the property, that plus the restrictions of the state rent laws made it impossible to handle it.

Q. What was the price at which you did offer it?

A. We would have lost five or ten thousand dollars if we could have got a ready purchaser.

Q. Did you sell this property at any time thereafter?

A. Yes.

Q. When was it sold and for what consideration?

A. We sold it to the Lefcourt Realty for $750,000 subsequently.

Q. What year was this?

A. That was 19— I think it was 1948.

Q. At that time were the restrictions off?

A. Yes.

Q. You have testified that you are familiar with the property of the petitioner, —

A. Yes.

Q. — it being across the street from your property. Based [fol. 146] on your experience and expert knowledge, what was the value of land in 1945 on which the Millinery Center Building stood?

Mr. Madden: Objection, if the Court please.

Mr. Weiss: All right, I will ask —

The Court: On what grounds?

Mr. Madden: I do not believe this witness has been shown to be qualified to give an expert opinion as to land values, if the Court please.

Mr. Weiss: I would like to qualify the witness.

By Mr. Weiss:

Q. Will you state how long you have been in the real estate business?

A. I have been in the real estate business for just 25 years this year, and spent most of that time in the garment center, almost all of the 25 years we made our headquarters down there, and we handle between 75 million and 100 million dollars worth of real estate at this moment.

Q. Again on the basis of your own experience and expert knowledge, what would you say is the value of the land?

A. Are you speaking —

Q. In 1945?

A. Are you speaking of land per se?

Q. The land exclusive of any improvement of any kind being on the property.

[fol. 147] A. $30 was a fair value at that point.

Q. You mean $30 a what?

A. $30 a square foot, sir.

Q. $30 a square foot?

A. That is right.

Q. You base that on what?

A. On the plot adjacent to 525 7th Avenue that the Wendels owned, that was 45,000 square feet and sold before we sold ours for $1,250,000, and they were hung up with it for quite some time, and the original purchasers lost money on it.

Now there has a big building been erected subsequently known as 1407 which entirely surrounds 525.

Q. When you say 1407, you mean 1407 Broadway?

A. 1407 Broadway, yes, sir.

Q. And this property which is called 1407 Broadway and fronts on Broadway also has a——

A. Has 100 feet on Seventh Avenue, on the corner of 39th Street.

We also had 501 Seventh Avenue which we managed for Mr. Timken which was just south of 515 Seventh Avenue, 24,300 square feet, 17 story building, similar occupancy as 525 Seventh Avenue.

Q. Did you offer your plot on the southeast corner of 38th Street and Seventh Avenue for rent in the years 1944 and 1945?

[fols. 148-155] A. For rent?

Q. Yes.

A. Well, we tried it. We were listening but we didn't get anything. Nothing developed. We would have liked to have at that point gotten anywheres from 35 to 40 thousand net per annum on it. We would have been glad to bail out.

Q. Would you say that $35,000 to $40,000 would have been a fair rental at that time?

A. Predicated on 6 per cent return of investment as free and clear.

Q. Would you say the fair rental value of the similar plot of or similar parcel of property located on the other side should bring about the same figure you now mention?

A. Yes. The big insurance companies have established that. In other words they would buy land under a building to permit them between five and six per cent.

Mr. Weiss: That is all.

[fol. 156] Whereupon, Edwin Mayer was called as a witness on behalf of the Petitioner, and having been first duly sworn, was examined and testified as follows:

The Clerk: State your full name, please.

The Witness: My name is Edwin Mayer, residing at 7 West 81st Street; office 10 East 40th Street.

Direct examination.

By Mr. Weiss:

Q. Will you please state what is your occupation?

[fol. 157] A. I am in the real estate business and have been in that business for the past 33 years.

Q. What was the nature of this business that you were engaged in, what phases of it?

A. I went into this business in 1919. At that time I was connected with—well, later I became vice-president of Realty Associates, Inc., and I was associated with various subsidiary corporations of Realty Associates which later became New York Investors and among their subsidiaries was the Prudence Company which was a mortgage loan company, Realty Associates Security Corporation, and numerous other subsidiary and allied corporations. I was with that company for approximately ten years, and from 1929 until 1932 I maintained an office at 225 West 34th Street in the real estate business. Also had an office at 189 Montague Street, Brooklyn, from 1932 to 1934. No, it was to 1935. I was associated with the real estate firm of Tankoos, Smith & Company, and I inaugurated and took care of their management and appraisal departments.

From 1935 until the present time I have had my own office. For the past—since I have had my own office—I have specialized in appraisal work more particularly in the Borough of Manhattan. Of course I did much appraisal work prior to that time. But prior to the time that I specialized in appraisal work, I bought and sold many millions of dollars of real estate in New York, also did a great deal of [fol. 158] building, everything from small one family homes to large apartment houses, manufacturing buildings, garages, in fact every type of structure. Did a great deal of

mortgage work and in fact every phase of the real estate business.

Q. What records do you maintain in your office with regard to real estate transactions?

A. I maintain records on cards, approximately 200,000 cards, one card for every piece of real estate in the Borough of Manhattan, and these cards go back to 1928, and on these cards there are pasted the clippings from the weekly publication known as the "Real Estate Record and Guide" which publication has been issued in the City of New York since 1879. That publication records every instrument that is recorded in the Hall of Records of the Borough of Manhattan having to do with real estate, conveyances, mortgages, satisfaction of mortgages, assignments of mortgages, auction sales, foreclosures, recorded leases, and every, as I say, every recorded transaction, so that I have and maintain in my office a running record of all real estate transactions in the Borough of Manhattan dating back to 1928, which enables me to keep very closely in touch with everything that is going on in real estate in the Borough of Manhattan, particularly with sales and the prices these properties are being sold and leased, mortgaged, and the like.

This record then, that I keep, has only one other of its kind in the City of New York, that is maintained by the [fol. 159] Real Estate Board of New York, Inc., and for a good many years I was chairman of the Records Committee of that Board, and I am not chairman of the Committee but I am still on the Records Committee and possibly the most active man in connection with the recording of the real estate bought.

I am a member of the Real Estate Appraisal Committee of the Board of New York. I am a member of the Legislation Committee and several other committees of the Board.

I am a licensed real estate broker.

Q. For what companies have you appraised property?

A. I started to jot down a list here in court before to refresh my memory. I will read from that list that I wrote, started to write. I can give you most of it from memory without referring to it.

I do all the appraisal work for the New York Central Railroad in the Borough of Manhattan and for the New York, New Haven and Hartford Railroad.

I have appraised properties for many banks in the City of New York, some of which are the City Bank Farmers Trust Company, the Empire Trust Company, Sterling National Bank, the Chemical National Bank and Trust Company, Corn Exchange Bank, the Manhattan Savings Bank, Union Dime Savings Bank, Seamen's Bank for Savings, New York Savings Bank; for various insurance companies: Metropolitan Life Insurance Company, New York Life Insurance Company, Reinsurance Underwriting Company, Mutual [fol. 160] Life Insurance Company; for many large operators and real estate owners in the City of New York such as Webb & Knapp, Paterno Estates, formerly known as Charles Paterno, now dead, Cruikshank, Brown, Benenson and others too numerous to mention.

The Court: Oh, I should think that this is sufficient.

By Mr. Weiss:

Q. About how many properties have you appraised and where were those properties located?

A. I never counted them, but I would say they are into many thousands. I would say upwards of four and five thousand properties in the Borough of Manhattan.

Q. What are some of the principal properties you appraised in midtown New York City area?

The Court: Let me say this—well, you can go ahead, but the Court is convinced his is an experienced appraiser.

The Witness: Some of the midtown properties: The Waldorf Astoria Hotel, the Biltmore Hotel, the Roosevelt Hotel, the Barclay Hotel, Park Lane Hotel, the Marguery at 270 Park Avenue, the square block at 277 Park Avenue running over to Lexington Avenue. And in the vicinity of the subject property under review in this proceeding, I have made appraisals of 513 to 519 Seventh Avenue which is immediately opposite the subject property located at the south [fol. 161] easterly corner of Seventh Avenue and 38th Street. This property at 1431 Broadway, 1435 Broadway, 1472 Broadway which is at the corner of 37th Street, 106 to

114 West 38th Street between Sixth Avenue and Broadway. 552 to 554 Seventh Avenue. 558 Seventh Avenue. 568 Seventh Avenue. 570 to 576 Seventh Avenue. 582 to 584 Seventh Avenue.

Mr. Weiss: I guess we are satisfied that you have the necessary——

The Court: Yes. The Court is satisfied that Mr. Mayer is an experienced appraiser.

By Mr. Weiss:

Q. What was the trend of land values in the years 1943, 1944 and up to say June of 1945 in the City of New York?

A. In my opinion the value remained constant, particularly in the neighborhood of the subject property or should I say specifically in the neighborhood of the subject property.

Q. How does the City of New York assess land value?

Mr. Madden: Objection, if the Court please.

The Court: What is the object, Mr. Weiss?

Mr. Weiss: The purpose of the question is to show that we are trying to—that in assessing value of the land or in fixing the value of land that you take the land unimproved, and vacant in determining its value, and I believe that the New York City law and the State of New York in determining assessed value, values for assessment purposes, bases these values on the land as if it were with no improve- [fols. 162-167] ments on it. And we are trying to obtain from the witness what was the value of land and how did they—trying to get what the law is if this witness knows it.

The Court: I cannot see the relevancy of what is the law in the City of New York with regard to assessments. We do not have any issue in this case with respect to assessments.

I sustain the objection.

By Mr. Weiss:

Q. In the light of your experience and expert knowledge, what was the value of the land as if vacant and unimproved in the year 1945 on which the building of the petitioner stood?

A. $660,000.

Q. How do you arrive at that value?

A. From a comparison and study of comparable sales in the immediate area of the subject property. And I have the information of those sales with me compiled and analyzed.

[fol. 168] By Mr. Weiss:

Q. What was the relative value of vacant and unimproved land and the rental for such land in the mid-1920's as compared to the year 1945?

A. I would say that in the mid-1920's, and that fixes it to say the year 1924 at the time this particular lease was originally made, those prices, and I use the word "prices" rather than the word "values", the prices at that time for leases and sales were between two and one-half and three times the values of 1945.

Q. Will you please discuss the question of the determination of land values by rent paid on long term leases?

[fol. 169] A. Will you read the question, please?

(Record read.)

Mr. Madden: I object, if the Court please.

The Court: I sustain the objection. The witness has given his opinion as to the value of the land in question without reference to any building. I think he said $660,000 on the date inquired about.

The Witness: That is right, sir, as if vacant and unimproved.

The Court: That is the way I understood it. Now you may of course interrogate the witness in any way you want to as to how he arrived at that. I think the purpose of the exhibit was to give some information along that line.

Mr. Weiss: I will ask the following questions—

By Mr. Weiss:

Q. Does rent income by itself determine the value of land?

A. No. Rental value is a determinative factor of the value of land, but some rental fixed at some previous period which perhaps was an inflationary period or boom period, some such a rental in and of itself does not fix the value of

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land as if vacant and unimproved. The rental value of that land at the time the appraisal is to be made is certainly a factor to be considered in fixing the value of that land.

Q. In other words, you have determined that the value [fol. 170] of the land was $660,000 in the year of 1945?

A. That is the value, yes, in my opinion.

Q. Now, what would be the rental value of the property worth this figure you mentioned, $660,000?

A. That would be $49,0[illegible] a year net.

Q. Would you say, then, that if this petitioner were paying an amount in excess of $40,000 rental that the excess is a price, say, to be relieved of——

Mr. Weiss: May I withdraw the question and put it this way——

By Mr. Weiss:

Q. You have stated that $40,000 is the fair rental value of the land on which the Millinery Center Building is located?

A. In 1945.

Q. In the year 1945. Do you consider that any price paid above that would be excessive in rent—any rental paid above $40,000 would be excessive?

A. That is axiomatic. Its value is $40,000 in 1945, and anything above that is more than its value in 1945.

Q. It has been stipulated in this case that a property located on the corner of 38th Street and Broadway, called Lot 55, Block 813, was sold to the Woodmen of the World Life Insurance Company for the price of $2,250,000. Now you have stated that the land value of petitioner's property was worth $660,000. How do you reconcile such a valuation [fols. 171-207] with respect to the Millinery Center property as against the price paid by Woodmen of the World for the 38th Street and Broadway property?

A. The deal wherein Woodmen of the World Life Insurance Society and Omaha Woodmen Life Insurance Society purchased that property was what we call in real estate parlance as a custom made or one in deal. Involved in that transaction there was a long-term net lease. I am trying to find the record of the lease. Just a minute. There was a long-term net lease. There was a very involved deal. I had the various recorded instruments noted on my card here in

the clippings. It was a lease extension from Wendel Foundation to Equity Development Corporation for 21 years, from 1945, at $18,000. That lease was assigned by Wendel Foundation to Woodmen of the World Life Insurance Society and Omaha Woodmen Life Insurance Society and without going through all of the various recorded instruments, the Woodmen of the World Life Insurance Society was buying an improved lot, not buying a piece of land. They were buying a lot sold with a building on it.

Q. Would you consider that the price that was paid was the value of the land?

A. It definitely was not. I have the sales of land plat, land sales right in the immediate vicinity of the subject property. They are contained within my booklet.

It is my opinion they reflected the value of land.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

MILLINERY CENTER BUILDING CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM—1955

MILLINERY CENTER BUILDING CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

Petitioner prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Second Circuit, entered in the above-entitled case on May 18, 1955.

Citations to Opinions Below:

The opinion of the Tax Court of the United States (R. 12-20) printed in Appendix "A" hereto, infra (p. 20-28) is reported in 21 T. C. 817. The opinion of the United States Court of Appeals for the Second Circuit, (R. 31-35) rendered on April 14, 1955, printed in Appendix "A" hereto, infra (p. 31-35) has not yet been officially reported.

NOTE: Unless otherwise indicated, numerical references in parenthesis preceded by letter "R" are to certified Record of Court of Appeals.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered on May 18, 1955 (R. 51). A timely petition for rehearing, printed in Appendix "A" hereto (p. 37-46) was denied on May 18, 1955 (R. 50-52) (p. 49). The jurisdiction of this court is invoked under 28 U. S. Code, Section 1254(1).

Questions Presented

1. Where a lessee, the owner of a valuable building on leased land, acquires the fee to the land to be relieved of what it considers to be the burdensome terms of a lease, may the lessee deduct the excess of the payment over the determined value of the land at the date of purchase as an ordinary expense of doing business under Section 23(a) of the United States Internal Revenue Code of 1939 or under section 23(f) as a loss on a transaction entered into for profit and not compensated for by insurance or otherwise.

2. In the alternative, may the lessee-petitioner consider the excess payment over the determined value of the land to be in the nature of a prepayment of rent for the remaining term of the extinguished lease and amortize such amount over 21 years?

3. In the further alternative, is the lessee-petitioner entitled to depreciate the payment in excess of the determined value of the land over the remaining economic life of the building under Section 23(l) of the United States Internal Revenue Code of 1939?

Statutes Involved

Pertinent provisions of the United States Internal Revenue Code of 1939, adopted by Act of February 10, 1939, Ch. 2, 53 Stat. 1504, applicable to this proceeding are:

"Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.

(1) Trade or business expenses.

(a) In general. All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *"

"Sec. 23. (f) Losses by Corporations.

In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise. * * *"

"Sec. 23. (l) Depreciation.

A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income. * * *"

"Sec. 272. Procedure in General.

(a) (1) Petition to the Tax Court of the United States.

If in the case of any taxpayer, the Commissioner determines that there is a deficiency in respect of the tax imposed by this chapter, the Commissioner is authorized to send notice of such deficiency to the taxpayer by registered mail. Within ninety days after such notice is mailed (not counting Saturday, Sunday or a legal holiday in the District of Columbia as the ninetieth day) the taxpayer may file a petition with the Tax Court of the United States for a redetermination of the deficiency. * * *"

Statement

The petitioner duly filed its petition for a redetermination of its excess profits tax liability for the calendar year 1945 with the Tax Court of the United States, which had jurisdiction over the proceeding in the first instance, in accordance with Section 272(a) of the United States Internal Revenue Code of 1939.

The Tax Court of the United States rendered its opinion on February 26, 1954, and entered its decision on March 22, 1954, on the basis of the pleadings, oral testimony, arguments and briefs. (Appendix "A"—R. 12-21) (p. 20-29)

It was determined by the Tax Court of the United States that the lessee petitioner (the owner of the building) was not entitled to deduct any part of a payment made by it to the owner of the land over and above the value of the land at the date of purchase of such land to obtain a cancellation of an onerous lease; that the payment made by the petitioner was for a "bundle of rights", no part of which was amortizable over the remaining term of the extinguished lease or depreciable over the remaining economic life of the building. (Appendix "A" R. 12-19) (p. 20-28)

The Tax Court was sustained by the United States Court of Appeals for the Second Circuit in its holding that the excess payment over the value of the land was a capital asset and could not be deducted as an expense or a loss or that any part of the payment to the owner of the property was amortizable (Appendix "A" R. 32-33) (p. 32-34) but agreed with the six dissenting judges of the Tax Court of the United States that the petitioner had additional building costs resulting from the purchase of the fee and was entitled to depreciation on the amount attributable to the building. (Appendix "A" R. 34) p. 34-35.

The judgment of the United States Circuit Court of Appeals was entered on May 18, 1955, reversing the Tax Court of the United States with respect to the right of the petitioner to be allowed depreciation on additional cost of building acquired by purchase. (Appendix "A" R. 35 p. 35)

Reasons for Granting the Writ

I.

The decision of the court below in the instant case is in direct conflict with the decision of the United States Court of Appeals for the Sixth Circuit in the case of *Cleveland-Allerton Hotel, Inc.* v. *Commissioner of Internal Revenue*, 166 F. 2d 805, set out in Appendix "B" hereto. (p. 51-56) Indeed, both the Tax Court and the United States Court of Appeals for the Second Circuit, in their opinions, Appendix "A" (R. 15, 32) p. 24, 32, noted the decision of the United States Court of Appeals for the Sixth Circuit but refused to follow the principles set forth in that decision. The factual situations in the instant case and in the *Cleveland-Allerton Hotel, Inc., supra*, are quite similar and the principles of law are identical.

In both cases, the lessee built a substantial building on land owned by the lessor, in the instant case, a 22-story

loft building on Seventh Avenue and 38th Street, New York City, at a cost of $3,000,000; whereas in the *Cleveland-Allerton Hotel* case, the hotel was built in the City of Cleveland by the lessee at a cost in excess of $267,000. In the instant case, the tenant had a lease for 21 years with an option to renew the lease for two successive terms of 21 years each, whereas in the *Cleveland-Allerton Hotel* case, the term was for 99 years and renewable in perpetuity. In each case the building was the property of the tenant for its useful economic life and in each case the lessee had the right to the use, rents and profits of the land for the term of the lease, subject to the obligation to surrender it at the end of the term, with this difference, that the lessee-petitioner in the instant case might be required to tear down the building at its own cost if the lessor refused to accept title to the building at the termination of the lease. (Appendix "A" R. 8, 32, pp. 16, 32) In each case the lessee sought to obtain relief from the onerous terms of the lease; in the present case, the tenant, at the time of renewal of its lease, found that the rental it was paying for the property was excessive to the extent of more than $78,000 per annum, whereas in the case of the Cleveland-Allerton Hotel, Inc., the rental it was paying annually was $15,000 over the fair rental value of the land. In neither case was a separate consideration stated for the value of the cancelled leasehold interest in the contract of sale. In each case the contract of sale required that the landlord cancel the lease and the lessee be discharged from the terms of the lease. (Appendix "A", R. 9, pp. 17, 53, 54)

The United States Court of Appeals for the Sixth Circuit determined that the excess price paid for the land over its fair market value without the lease represented an allowable deduction as an expense of doing business, in accordance with Section 23(a) of the Internal Revenue Code of

1939 to escape from a burdensome lease. (Appendix "B", p. 55)

The United States Court of Appeals for the Second Circuit does not subscribe to the views expressed by the United States Court of Appeals for the Sixth Circuit and considers the whole consideration paid as a capital item. (Appendix "A", R. 32, 33, p. 33)

In each case the lessee-petitioner claimed in the alternative that the excessive amount paid over the value of the land at the date of purchase should be written off over the term of the lease or over the remaining economic life of the building. (Appendix "A", R. 12, p. 20; Appendix "B", p. 53)

The United States Court of Appeals for the Sixth Circuit, having determined the excessive amount paid for the land was deductible in full in the year of purchase of fee and the discharge of the lease as an ordinary and necessary expense under Section 23(a) of the United States Internal Revenue Code of 1939, did not have to pass on the alternative claims. (Appendix "B", p. 56)

The United States Court of Appeals for the Second Circuit determined that no part of the excessive amount was amortizable though it found that the petitioner's second alternative claim for depreciation of building should be allowed. (Appendix "A", R. 34, p. 34)

II.

Clearly the difference in legal principles derived from the same set of facts by two different United States Circuit Courts of Appeal requires that this Court grant certiorari to settle the question. Petitioner's attorneys are advised that a great many cases are pending in the various Circuits where the same question is involved. Most certainly the question presented is of great importance to the

administration of the Federal tax statutes and attorneys are entitled to have the law settled so as to properly advise their clients.

III.

The decision of the Court of Appeals in this proceeding is believed to be clearly wrong in its failure to allow as an ordinary expense of doing business the full amount of the excess payment incurred to be relieved of a burdensome lease. The decision of the United States Court of Appeals for the Sixth Circuit in the *Cleveland-Allerton Hotel, Inc., supra,* is clearly correct.

Support for the principle expressed therein by the United States Court of Appeals for the Sixth Circuit may be found in the decision of the United States Court of Appeals for the Ninth Circuit in *Stuart* v. *Commissioner of Internal Revenue,* 195 F. 2d. 176 (1952). Deductions of amounts paid by a tenant to obtain the cancellation of a lease were allowed in the cases of *Cassatt* v. *Commissioner,* 137 F. 2d. 745 (3rd CAA) 1943; *Denholm & McKay* v. *Commissioner,* 2 B. T. A. 444.

The incurring of an expense to reduce the total cost of operating a trade or business is so obviously allowable it is unnecessary to quote authority for its deductibility. By making the payment of $2,100,000 to the lessor of the property for the value of land determined by the Tax Court of the United States, on the basis of competent authority, to be worth only $660,000, the petitioner paid $1,440,000 to be relieved of the onerous terms of the lease under which it was required to pay the sum of $2,495,640 in rentals over the next 21 years, whereas the fair rental value of the land over the next 21 years was only $840,000, according to undisputed authoritative evidence produced before the Tax Court of the United States.

IV.

The taxpayer claims alternatively that if the $1,440,000 ($2,100,000 less $660,000 value of land) is not allowable as a deduction in full in the year 1945; then this amount is in the nature of prepaid rent and the petitioner is entitled to amortize said amount over the period benefited, i.e. 21 years. Since the fair rental value of the land for the next 21 years did not exceed $840,000 (21 x $40,000) that part of petitioner's payment in excess of the determined value of the land, or $1,440,000, was for all practical purposes payment for the balance of the rent of $1,655,640 for the next 21 years.

V.

To illustrate one instance that prepayment of expenses may be written off over the period benefitted, the attention of this Honorable Court is directed to the case of *Laird Bell* v. *Harrison*, 212 F. 2d 253, decided by the United States Court of Appeals for the Seventh Circuit (4/27/1954). In that case a trust remainderman purchased the life interest of his parents, amortizing the cost of the life estates over the life expectancy of his parents. The Circuit Court dismissed the Commissioner's contention of merger of life estate and remainder estate and considered the amount paid to be prepayment for income to be received, which prepayment, being a wasting asset, was recoverable over the period that the taxpayer would benefit.

VI.

In the further alternative, taxpayer claims that if the excess payment to the lessor over the value of the land is not allowable as a deduction in full in 1945 or amortizable over the 21-year period benefitted, then such excess represents additional building cost depreciable over the agreed 30-year remaining economic life of the building.

VII.

Though title to the building was nominally in the petitioner, actual ownership for all practical purposes was in the lessor. Petitioner's right to the use, rents and profits of the building flowed from the lease and not from title ownership. Under the terms of the lease, even the nominal title to the building passed to the lessor upon termination of the lease (Appendix "A", R. 7, p. 16). Under the agreement of June 11, 1945, the lease was cancelled simultaneously with the purchase of the fee (Appendix "A", R. 8, 9, p. 16, 17). Therefore the petitioner acquired immediate title to the land and the building and not merely a reversionary interest in the building.

In accordance with Section 23(l) of the United States Revenue Code of 1939, petitioner is entitled to recover the value ascribed to the building at the date of purchase over the agreed remaining economic life of 30 years.

Conclusion.

For the foregoing reasons, this petition for writ of certiorari should be granted.

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APPENDIX A

Findings of Fact and Opinions.

[233]

21 T. C. No. 92

THE TAX COURT OF THE UNITED STATES

MILLINERY CENTER BUILDING CORP. (now Fashion Center Building Corp.),

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 36321. Promulgated February 26, 1954.

1. Petitioner purchased land which it had under lease for a period of 21 years for a consideration of $2,100,000. The fair market value of the land was $660,000, if it had been unimproved on the date of purchase. Petitioner claims that the remaining $1,440,000 was paid to secure the cancellation of a burdensome lease which had 21 years to run. Petitioner claims deduction of the $1,440,000 which, it maintains, should be allocated to the cost of canceling the lease as an ordinary and necessary business expense under section 23(a) of the Code. *Held*, the $1,440,000 is not deductible in the year paid as an ordinary and necessary business expense. *Cleveland Allerton Hotel, Inc.* v. *Commissioner*, 166 F. 2d 805, reversing T. C. Memorandum Opinion, not followed.

[234] (2) In the alternative, petitioner claims that it should be permitted to amortize over the remaining term

of the lease all that it paid in excess of the value of the land, if it had been unimproved at the time of purchase as the cost of canceling a burdensome lease. *Held*, that petitioner, in procuring the cancellation of its lease as a part of the transaction in acquiring the land, did not acquire a capital asset in the cancellation of its lease and has no legal ground for the amortization deduction which it claims under its first alternative.

(3) In its second alternative, petitioner claims that all that it paid in excess of the fair market value of the land in an unimproved condition should be allocated as additional cost of its building and that it should be allowed depreciation based on this additional cost spread over the remaining useful life of the building. *Held*, that petitioner already owned the building and had been permitted to recover by way of depreciation, including the amount of depreciation allowed by the Commissioner in the taxable year, the full amount of the cost of its building and has no unrecovered cost which it is entitled to recover by way of depreciation. It has no additional cost of its building by reason of the transactions here.

[235] 4. In the taxable year petitioner incurred and paid $16,500 attorneys fees in acquiring title to the land and cancellation of the lease. The Commissioner disallowed petitioner the deduction of said amount on the ground that it was a capital expense. *Held*, the expenditure was made in the acquiring of capital assets and is not deductible.

Bernard Weiss, Esq., and Sidney Gelfand, Esq., for the petitioner.

John J. Madden, Esq., for the respondent.

The Commissioner has determined a deficiency in petitioner's excess profits tax for the year 1945 of $39,465.62. The deficiency is due to five adjustments made by the Commissioner to the income as reported by petitioner on its return. These adjustments were:

(a) Capital Stock Tax.	$ 5,000.00
(b) Legal Expense	16,500.00
(c) Prepaid Rent	8.33
(d) Depreciation	15,679.32
(e) Net short term capital gain	1,899.38
Total	$39,087.03

Adjustment (b) is explained in the deficiency notice as follows:

> (b) Deduction of legal expenses, in the amount of $16,500.00, incurred in connection with the acquisition of your property has been disallowed because it represents a capital expense.

Adjustment (d) is explained in the deficiency notice as follows:

> (d) A reasonable allowance for the depreciation of your building and improvements is determined to be $65,330.57, rather than the amount of $81,009.89 deducted in your return.
>
> No allowance has been made with respect to a payment by you to allegedly obtain the cancellation of a lease, in the absence of information showing that a deductible business expense was incurred.

In its original petition petitioner made two assignments of error:

> a) The Commissioner of Internal Revenue has failed to allow as a deduction an ordinary and neces-

sary business expense in the amount of $1,600,000.00 incurred to secure a release from a 21 year lease with a minimum rental of approximately $225,000.00 per annum.

[236] b) Alternatively to sub-paragraph (a) above, petitioner contends the Commissioner of Internal Revenue has failed to allow an additional deduction for depreciation in the amount of $35,961.60.

At the hearing petitioner filed an amended petition changing paragraph (b) above and adding (c) and (d), as follows:

(b) Alternatively to sub-paragraph (a) above, petitioner contends the amount paid in excess of the value of the land, namely $1,500,000., should be amortized over a period of 21 years. Commissioner of Internal Revenue has failed to allow a deduction for such amortization.

(c) In the further alternatives to sub-paragraphs (a) and (b) above, Commissioner of Internal Revenue has failed to allow an additional deduction for depreciation in the amount of $36,000.00.

(d) Commissioner of Internal Revenue has failed to allow as a deduction that part of the legal expense in the amount of $16,500.00 and sundry expense in the amount of $4,552.50 incurred in connection with obtaining a release by the petitioner from its lease agreement with the landlord.

The respondent's other adjustments are not contested.

Some of the facts have been stipulated and are found accordingly.

Petitioner is a corporation with its principal office in New York City. The returns for the period involved here were filed with the collector for the third district of New York.

On April 30, 1924, petitioner leased land located at the northeast corner of Seventh Avenue and 38th Street, New York City. The size of the plot is 98 feet 9 inches on the east side of Seventh Avenue and 200 feet on 38th Street. The lease provided for an annual net basic rental of $100,000, plus the income taxes that would be incurred by the lessor upon the receipt of the $100,000 per annum. The lease between petitioner and the landlord [237] was amended on November 30, 1935, to provide for an annual net rental of $118,840 without petitioner being liable for reimbursing the landlord for any income tax thereon. On April 16, 1945, petitioner exercised the option contained in the lease agreement to extend the lease for a period of 21 years to April 30, 1966.

In accordance with the terms of the lease, the petitioner-tenant erected a 22-story loft building at a cost of $3,000,000, including taxes, interest and insurance during construction on the leased land. Title to the building, improvements and fixtures belonged to the tenant-petitioner. Title to this property was to vest in the landlord at the expiration of the last term of the lease only at the option of the landlord. In the event of the destruction of the building by fire or other causes, the petitioner-tenant was still liable on the lease and could not abandon the lease. In the event of the destruction, in whole or in part, of the building petitioner-tenant at its own cost had to make the

building whole. At the expiration of the lease or any renewal period, petitioner-tenant was to surrender the premises and the building to the landlord at his option, free and clear of all encumbrances, without the landlord being obligated to pay for such property. Petitioner-tenant had the option to renew the lease for two successive 21-year periods. The ground rent for the renewal period was to be six per cent of the value of the land at the termination of each period of the lease but not to be less than the basic rent of $100,000, plus the additional rent of $18,840. The value of the land was to be determined as if vacant and unimproved. The rent at six per cent of the value of the land in May 1945, would have been less than the minimum basic rental of $100,000.

[238] On May 11, 1945, petitioner entered into an agreement of sale with Wendel Foundation, the owner of the land. Title to the land was taken by petitioner on June 11, 1945. Petitioner purchased the fee and obtained release from the obligations of the renewed lease for $2,100,000. Petitioner purchased the fee to be released from the terms of the lease. Petitioner was most concerned about the annual rental of $118,840, which it deemed excessive, and the contingent liability to remove the building from the premises at the expiration of the lease upon the request of the landlord. The agreement of sale between Wendel Foundation, the lessor and owner of the fee, and petitioner contained, among other provisions, the following:

> WITNESSETH that the Seller agrees to sell and convey and the Purchaser agrees to purchase:
>
> [Here follows a description of the premises.]
>
> The price is Two Million One Hundred Thousand Dollars ($2,100,000) payable as follows: Two Hun-

dred Ten Thousand Dollars ($210,000) on the signing of this contract, receipt whereof by check subject to collection is hereby acknowledged, the non-payment of which check in due course shall give Seller the option of cancelling this agreement; and the balance, One Million Eight Hundred Ninety Thousand Dollars ($1,890,000) on the delivery of the deed as hereinafter provided, by certified check satisfactory to the Seller, the check to be drawn to the order of the Seller and payable through the New York Clearing House.

* * * * *

Seller shall execute upon request of Purchaser an agreement cancelling and terminating said lease as of the time of the actual closing of title hereunder. It is agreed however that regardless of whether Purchaser accepts title to the premises subject to the aforementioned lease or elects to have an agreement cancelling and terminating same, the idemnity [sic] agreements of Purchaser contained in the said lease shall continue in full force and effect after closing of title in favor of the Seller with respect to any liabilities or obligations of Seller assumed by or imposed upon it by the terms of the lease or any such agreements of amendment, modification, extension or renewal or arising out of Seller's ownership of the said premises.

* * * * *

[239] The deed shall be in proper statutory short form for record in the usual form of a Bargain and Sale deed containing no covenant or warranty and shall be duly executed and acknowledged by Seller at Seller's expense, * * *

The agreement of cancellation of the lease was executed June 11, 1945, and contains, among other things, the following language:

> WHEREAS, the Tenant requested the Landlord to accept a surrender of the demised term and the Landlord agreed to accept such surrender provided this agreement was executed simultaneously with the execution of the formal agreement of surrender, which formal agreement of surrender is being executed and delivered simultaneously herewith:
>
> NOW, THEREFORE, in consideration of the premises and the sum of One Dollar ($1.00) and other good and valuable consideration by each of the parties hereto to the other in hand paid, receipt whereof is hereby acknowledged, the parties hereto do hereby mutually release one another and their successors and assigns from any and all obligations under said lease and modification agreement and under said agreement of renewal and extension thereof, * * *

The land purchased by petitioner contained 19,750 square feet and was located in Block No. 814, bounded by 38th Street, Seventh Avenue, 39th Street, and Broadway. The Millinery Center Building and the land on which it stood, were assessed for real estate tax purposes as follows:

	Land	*Building*	*Total*
1943-1944	$1,470,000	$2,305,000	$3,775,000
1944-1945	1,410,000	2,165,000	3,575,000

The remainder of Block No. 814, comprising 45,178 square feet and improvements thereon, was sold on De-

cember 2, 1943, for $1,250,000. This property had a frontage of 205 feet on the west side of Broadway, 301 feet on 39th Street, 165 feet on 38th Street, and 98 feet and 9 inches on Seventh Avenue, and was assessed for real estate tax purposes as follows:

[240]

	Land	*Building*	*Total*
1943-1944	$3,830,000	$ 115,000	$3,945,000
1944-1945	3,735,000	100,000	3,835,000

Lot 64 of Block No. 813 on the southeast corner of 38th Street and Seventh Avenue had the same frontage with identical dimensions as the property in question and was located directly across the street. Lot 64 was offered for sale in 1945 for an amount less than $600,000 but remained unsold. That lot with improvements was previously sold on March 1, 1944, for $600,000. This property was assessed for real estate tax purposes as follows:

	Land	*Building*	*Total*
1943-1944, and 1944-1945	$1,225,000	$35,000	$1,260,000

Lot 55, Block No. 813 was leased in December 1924 by the landlord for a net basic rental of $115,000, plus the income taxes thereon, for a term of 21 years with two renewal options of 21 years each. The rental was changed to $138,000 in lieu of $115,000, plus the income tax thereon. Pursuant to the terms of the lease, the lessees had erected a 23-story building which was completed in 1926. The lease was renewed on April 26, 1945. On May 8, 1945, the fee to the land, on which was the building erected by the tenant and subject to a long-term lease, was sold to the Woodmen of the World for $2,250,000.

In 1945, the United States Government restrictions on building construction plus the restrictions contained in New York State rent laws adversely affected the value of land. Limitations Order L-41 restricting building construction became effective in 1942 and was still in effect through the year 1945.

[241] The value of the land, vacant and unimproved, upon which the petitioner's property stood was $660,000 when purchased by petitioner in 1945.

Petitioner incurred legal fees aggregating $16,500 in connection with the purchase of the fee and the release from the obligations under its lease with the Wendel Foundation.

Opinion.

BLACK, *Judge*: Petitioner states the issues raised by the pleadings, in its brief, as follows:

I.

Is the petitioner entitled to deduct the amount of $1,500,000 or any part thereof incurred in connection with the cancellation of a burdensome lease as an ordinary and necessary expense under Section 23(a) or as a loss under Section 23(f) of the Internal Revenue Code? Or, in the alternative, is the petitioner entitled to amortize the said $1,500,000 or any part thereof incurred in obtaining a release from the burdesome 21 year lease over the remaining term of such lease?

II.

In the further alternative, is the petitioner entitled to capitalize that part of the price paid of

$2,100,000 over and above the actual land value as the purchase price of the building and depreciate said cost of building over the remaining building life of 30 years?

III.

Is petitioner entitled to deduct that part of the $16,500.00 legal expenses incurred to acquire the fee and to cancel a burdensome lease that is applicable to the cancellation of the burdensome lease?

The principal issue in this proceeding is whether petitioner, a lessee in possession who purchases the fee and the cancellation of the lease for a price greater than the value of the land, may allocate a portion of the purchase [242] price to the purchase of the lease and deduct the allocated portion as a business expense under section 23(a). Respondent in his deficiency notice determined that "No allowance has been made with respect to a payment by you to allegedly obtain the cancellation of a lease, in the absence of information showing that a deductible business expense was incurred." Respondent still contends that no part of the purchase price of $2,100,000 paid by petitioner in 1945 to the Wendel Foundation can be deducted as a business expense nor is petitioner entitled to use any part of this purchase price as a basis for amortization or depreciation deductions. For reasons which we will presently give, we think respondent must be sustained in each of these contentions.

Business Expense.

Petitioner paid $2,100,000 under the agreement of May 11, 1945, to the Wendel Foundation. Credible and uncontradicted testimony placed the value of the land at $600,000.

if it had been in an unimproved condition at the time of purchase. But it must be remembered that petitioner did not purchase the land in an unimproved condition. The land, when petitioner purchased it in 1945, was improved by a building which had been erected by petitioner in a prior year at a cost of $3,000,000, and the land was leased to petitioner for a term of 21 years still to run at an annual rental of $118,840. What petitioner paid Wendel Foundation $2,100,000 for was the bundle of rights which it obtained in the purchase. Included in this bundle of rights was the cancellation of the lease which still had 21 years more to run. Petitioner contends that all above $660,000, which was the value of the land if it had been in an unimproved condition, or $1,440,000, represented the price which it paid for the cancellation of its lease and that [243] this entire amount of $1,440,000 should be allowed in the taxable year 1945 as a deductible business expense under section 23(a) of the Code printed in the margin.[1] Petitioner, in contending that the entire amount of $1,440,000 should be allowed as a deduction for business expense in the

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[1] SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

taxable year, relies heavily upon *Cleveland Allerton Hotel, Inc. v. Commissioner*, [195] F. 2d 803, reversing T. C. Memorandum Opinion. In that case the court of appeals said:

> As purely legalistic formalism, this argumentation bears an aura of validity. Realistically considered, however, it will not stand analysis. The status of the petitioner does not approximate that of a third person investor, buying real estate to which is appurtenant a long-term profitable lease. The petitioner already had the use of the land with full control and dominion over it, subject only to its obligation to surrender it at the end of the term. The lease was a liability which it sought to extinguish. This it was impossible to do merely by buying acquittance and giving up possesion of the premises. It had thereupon a valuable hotel building which it could not take away with it. The only interest in the land it secured by the purchase that it did not already have was the reversionary interest, which all parties appear to consider as of only nominal value. To consider that remainder a capital asset with a value of $441,250 requires, [244] it seems to us, a naivete not attributable to experienced and sophisticated taxing authority. * * *
>
> If numerous admonitions that taxation is a practical matter, that taxing authority may look through form to substance, is not mere rhetoric where the taxpayer's interests is involved, and a working formula only when it is of advantage to the Treasury, it would seem to be clear that the petitioner paid all over $200,000 to escape from a burdensome lease, and should be able to write that off as an expense of doing business.

We are unable to agree with the learned court that in a case like the *Cleveland Allerton Hotel* case or the one which we have here, the taxpayer should be allowed to deduct as a business expense in the year when paid that part of its payment which it claims should be allocated to the cancellation of a burdensome lease. The court in holding that the amount which the taxpayer claimed should be allocated to the cancellation of the burdensome lease and should be allowed as a deductible business expense in one year said:

> This being so, we find ourselves in accord with the decision of the Third Circuit in Cassatt v. Commissioner, 3 Cir., 137 F. 2d 745 and with the decision of the Board of Tax Appeals in Appeal of Denholm & McKay Co., 2 B. T. A. 444, that payments of this character must be deducted on the taxpayer's tax return as an expense of doing business in the year when made. * * *

We think *Cassatt* v. *Commissioner*, 137 F. 2d 745, affirming 47 B. T. A. 400, and *Denholm & McKay Co.*, 2 B. T. A. 444, are distinguishable. In *Denholm & McKay Co.*, the taxpayer did not own the building which it was renting. Both building and land were owned by the Denholm & McKay Realty Co. and what the taxpayer purchased from the Realty Co. was a complete cancellation of the lease and a surrender of possession under that particular lease and the securing of a new lease of the same building under much more favorable terms than the old lease. Denholm & McKay did not acquire title to the land from the Realty Co. In *Cassatt* v. *Commissioner*, *supra*, the court pointed out that:

> [245] In the early part of January, 1935, Cassatt and Company were obligated on several leases of office

> space for terms not expiring until 1941. The aggregate prospective rentals for these leases was $1,076,000. A settlement was effected with the various landlords whereby for $340,524.00 the leases were cancelled for the unexpired terms. * * *

Thus, in that case there was not only a cancellation of the leases but a complete surrender of possession thereunder to the landlords.

We have no such case here. As we have already pointed out, petitioner, in making purchase of the cancellation of the lease from Wendel Foundation, had no notion of surrendering possession to the landlord. If it had done so, we would, of course, have an entirely different case from the one we have here. It owned a 22-story steel and concrete building which, according to testimony, had a remaining useful life of 30 years. What petitioner purchased for $2,100,000 is shown in its contract of purchase dated May 11, 1945, followed by the deed to the property which petitioner received on June 11, 1945. Petitioner purchased a capital asset and we sustain the Commissioner in his determination that no part of the purchase price can be deducted as a business expense in 1945. Cf. *Home Trust Co.* v. *Commissioner*, 65 F. 2d 532.

Claim for Amortization Deduction.

Petitioner's first alternative is stated thus in its brief:

> However, in the event the Court should find that the amount paid in excess of the land value to effect a saving in rent expense is a capital asset, petitioner then claims it is entitled to amortize said asset over 21 years, the remaining life of the cancelled lease.

[246] Petitioner does not cite any authority in support of this first alternative contention and we do not know of

any. It is, of course, true that if a taxpayer purchases a lease which has, say 21 years to run, and does not purchase the fee his purchase is a wasting asset and the cost of the lease is not deductible in the year of purchase but must be amortized over the life of the lease. See *Home Trust Co. v. Commissioner, supra,* and many cases there cited. But here petitioner has not purchased any lease. In the transaction which has been consummated petitioner has obtained title to the land and has secured the cancellation of the lease which, under the circumstances then existing, it regarded as burdensome. It is true, of course, that petitioner in the purchase of land acquired a capital asset but it is not an asset which is subject to depreciation or amortization. Its value may increase from year to year or, on the other hand, may decrease but gain or loss can be taken only when the land is finally disposed of. But, while it is true that petitioner in the purchase of the land in 1945 acquired a capital asset, we do not think it can be said that petitioner in procuring the cancellation of its burdensome lease acquired a capital asset which it can amortize over the remaining term of the lease. The lease was at an end when petitioner procured its cancellation in 1945. We think petitioner's first alternative contention must be denied.

Additional Depreciation on the Building.

Petitioner's second alternative is stated in its brief as follows:

> In the event the Court should find that no part of the payment of $2,100,000 represents an allowable deduction for obtaining a release from a lease agreement, petitioner then contends that $1,500,000 represents the cost of building which it is entitled to depreciate over a remaining life of 30 years.

[247] The following fact with reference to depreciation seem to be undisputed by the parties: The respondent, for the taxable year, has allowed petitioner depreciation on the building equivalent to petitioner's unrecovered cost because its first 21-year term of the lease ended in 1945. That depreciation deduction is not in dispute here. During this original 21-year term of the lease, including the part of it which expired in 1945, petitioner has recovered tax free through depreciation deductions the entire $3,000,000, cost of erecting its building. Petitioner has claimed, however, on its return for 1945, that it acquired the building in effect for the second time in 1945 and has claimed depreciation on this second cost. This latter amount of depreciation the Commissioner has disallowed and has confined his allowance for depreciation deduction petitioner's unrecovered cost of its building. Petitioner having fully recovered the cost of its building by way of depreciation deductions in 1945 and prior years had no unrecovered cost of its building.

We think that the bundle of rights which petitioner acquired by its contract of purchase of May 11, 1945, followed by the deed of June 11, 1945, was so inextricably entwined in the acquiring of the land as not to be separable therefrom. We think that no part of the $2,100,000 which petitioner paid can be allocated to the cost of the building which petitioner already owned and which it had been allowed to fully depreciate over the first 21-year term of the lease. The building and the lease were not bargained for or purchased separately. They were included, in so far as the lessor had any interest therein, in the single transaction of the contract [248] of purchase of the land and the deed to petitioner thereof. If petitioner were allowed additional depreciation deductions for the building which it claims in its second alternative, it would then have de-

preciated the building once since it has been erected and paid for by petitioner and a second time because it has purchased the land under the building. Petitioner cites no case which would support such a deduction and we know of none. Petitioner's second alternative is denied.

The only other issue which remains for our decision was stated in petitioner's brief as follows: "Is petitioner entitled to deduct that part of the $16,500.00 legal expenses incurred to acquire the fee and to cancel a burdensome lease?" The Commissioner in his disallowance of this deduction stated in his deficiency notice: "Deduction of legal expenses, in the amount of $16,500.00, incurred in connection with the acquisition of your property has been disallowed because it represents a capital expense." We think the Commissioner must be sustained in the disallowance of this claimed deduction. It was made to obtain capital assets and, as such, did not represent a deductible expense.

Reviewed by the Court.

Decision will be entered under Rule 50.

WITHEY, *J.*, concurs in the result.

[249] ARUNDELL, MURDOCK, OPPER, TIETJENS, RAUM and RICE, *JJ.*, dissenting. Some part of the purchase price should be allocated to the additional rights in the building acquired in the purchase, using the principle of *Cohan* v. *Commissioner*, 39 F. 2d 540, if necessary. This additional cost of the building would then be recovered through depreciation.

Decision.

[250]

THE TAX COURT OF THE UNITED STATES

WASHINGTON

Docket No. 36321

MILLINERY CENTER BUILDING CORP., (now Fashion Center Building Corp.),

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Pursuant to the Findings of Fact and Opinion of the Court promulgated February 26, 1954, the parties on March 22, 1954, having filed an agreed computation of the tax, now therefore, it is

ORDERED and DECIDED: that there is a deficiency in excess profits tax for the taxable year 1945 in the amount of $39,465.62.

(Signed) EUGENE BLACK

Judge

Enter:

Entered Mar 22 1954

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 127—OCTOBER TERM, 1954.

Argued March 15, 1955 — April 14, 1955

Docket No. 23150

MILLINERY CENTER BUILDING CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Before CLARK, Chief Judge; FRANK, Circuit Judge, and GALSTON, District Judge.

Petition to review a decision of the Tax Court of the United States. Eugene Black, Judge.

Petitioner, Millinery Center Building Corporation, seeks review of a decision, 21 T.C. 817, finding a deficiency in its excess profits tax for 1945, based on disallowance of deduction, depreciation, or amortization of sums expended in cancellation of a lease through acquisition of, and merger with, the underlying fee. Reversed and remanded.

Charles Korn, New York City (Bernard Weiss, New York City, on the brief), for petitioner.

Carolyn R. Just, Sp. Asst. to Atty. Gen., Washington, D. C. (H. Brian Holland, Asst. Atty. Gen., and Ellis N. Slack, A. F. Prescott, and Louise Foster, Sp. Assts. to Atty. Gen., Washington, D. C., on the brief), for respondent.

CLARK, Chief Judge.

This petition for review contests the finding of a deficiency in petitioner's excess-profits tax for 1945, based on the refusal to allow as a business expense the amount paid to terminate an allegedly burdensome lease. The issue concerns the tax consequences of a contract between the taxpayer and its landlord whereby the taxpayer acquired the real estate in question and thus obtained cancellation of the lease. The taxpayer as tenant and at its own cost had erected a 22-story loft building on the leased premises, to belong to the taxpayer only as long as the lease was in force and at termination to be either razed or surrendered to the landlord, as the latter might direct. The lease had been renewed by the tenant for an additional 21-year term just before the contract of sale was entered into, although the tenant now urges that the annual rental of $118,840 was excessive, notwithstanding the very substantial rents it was collecting, sufficient at least to make the renewal desirable. Petitioner's main argument throughout this litigation has been that the difference between the purchase price of $2,100,000 and the unimproved value of the land, $660,000, namely the sum of $1,440,000, should be deductible as an ordinary business expense under I.R.C. §23(a) as the price of cancellation of an onerous lease. Alternatively it suggested amortization of this amount over the unexpired term of the lease, or its depreciation as an additional cost of acquiring the already fully depreciated

building. All this the Tax Court denied, although six judges dissenting thought that some part of the purchase price should be allocated to the additional rights thus acquired in the building and then be recovered through depreciation. 21 T.C. 817.

The Tax Court refused to permit deduction under I.R.C. § 23(a) because it considered the $2,100,000 contract price as payment for one complete bundle of rights of land ownership, more appropriately characterized as a capital asset than as an ordinary business expense. With this conclusion we are in agreement, despite the contrary opinion of the Sixth Circuit in *Cleveland-Allerton Hotel* v. *C. I. R.*, 6 Cir., 166 F. 2d 805.[1] Whatever may be the case where a lease is cancelled without the purchase of a fee, we think that the situation here at hand consists of the acquisition of a definite and substantial property interest, so to be viewed for tax purposes. Petitioner, having certain rights in the property, bought all the remaining ones up to full ownership and is in the same situation as if it had bought out the share of a co-owner or an overriding easement or, indeed, a piece of land next door. Because petitioner also happened to be the tenant under the lease, its purchase resulted in the merger of the leasehold in the fee and gave it a good bargain. But that fact, while it may explain the motivation for the investment, cannot change its fundamental nature from the acquisition of a capital asset to mere removal of a burden or repair of plant. *Post* v. *C. I. R.*, 2 Cir., 109 F. 2d 135; *Herzberg* v. *Alexander*, D.C.W.D. Okla., 5 F. Supp. 334;

[1]This case is criticized in Notes, 48 Col. L. Rev. 967 and 1 Stan. L. Rev. 147. Both notes suggest that the court erred in considering the investment to be other than a capital asset. Both equally reject the solution of the Tax Court in that case and this one that no depreciation whatever be allowed, suggesting as an alternative amortization over the remaining term of the lease.

Boos v. *C. I. R.*, 30 B. T. A. 882; and see *Willcut* v. *Minnesota Tribune Co.*, 8 Cir., 103 F. 2d 947, 952, certiorari denied *Minnesota Tribune Co.* v. *Willcuts*, 308 U.S. 577. We reach this result whether or not the lease was in fact onerous to the taxpayer, as it contends; the Tax Court made no such finding and the evidence in this respect is doubtful at best. But that merely goes to the desirability or otherwise of the bargain; it does not define what was bought. We are equally in accord with the Tax Court that the purchase price of the fee is not to be amortized over the remaining term of the now nonexistent lease. Since the taxpayer has acquired the complete title to the property in question, it obviously no longer has a wasting asset to come to a necessary end twenty-one years hence. See *Post* v. *C. I. R.*, *supra*, 2 Cir., 109 F. 2d 135; *Friend* v. *C. I. R.*, 7 Cir., 119 F. 2d 959; certiorari denied 314 U. S. 673. But we do think the view of the dissenting judges sound that here is a new purchase price covering a building to be recovered taxwise, as is any building cost, over the period of its useful life.

The taxpayer's second alternative raised this issue in arguing that $1,440,000 be added for depreciation purposes to the cost of the building which it erected on the property. The cost of $3,000,000 originally invested by it in the building was fully written off during the first 21-year term of the lease. From this, a majority of the Tax Court concluded that no further depreciation was allowable, since the taxpayer's cost of acquisition had been recovered. But the dissent seems more in accord with the realities of this situation. The taxpayer in acquiring this fee bought not only a reversionary interest in the land itself, but also a reversionary interest in the building which under the lease it would have had to surrender to the landlord when its term expired. A third-party purchaser of such a fee would be entitled to allocate part of its cost to the building

and to depreciate it as such. Similarly, this taxpayer has made an additional investment in the building which should give rise to an added depreciation deduction in accordance with I. R. C. § 23(l).

On the present state of the record we cannot determine how much of the $2,100,000 purchase price is properly to be allocated to the land and how much to the building. The Tax Court has found only that in its unimproved state the land was worth $600,000. That appraisal cannot be considered as conclusive of its present value, improved by a $3,000,000 building appurtenant thereto. We doubt if a merely mechanical apportionment will adequately fix the intrinsic value of the building reversion. Hence we must remand this case to the Tax Court to take evidence, if desired, and otherwise to fix this value. See *Cohan* v. *C. I. R.*, 2 Cir., 39 F. 2d 540, 543, 544. A similar adjustment should be made with respect to the legal fees of $16,500 incurred by the taxpayer in connection with this purchase. The value so found will be the cost to be recovered through yearly depreciation.

Reversed and remanded for further proceedings in accordance with this opinion.

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 127—OCTOBER TERM, 1954

MILLINERY CENTER BUILDING CORPORATION, *Petitioner*, v. COMMISSIONER OF INTERNAL REVENUE, *Respondent*.	Docket No. 23150

PETITION FOR REHEARING

To the United States Court of Appeals for the Second Circuit and the Honorable Judges thereof.

The above named petitioner hereby respectfully petitions for a rehearing which the Court has inherent power to grant to prevent injustice, pursuant to Rule 25 of the Court's Rules and in support thereof shows:

The Court's opinion in this proceeding, filed April 14, 1955, holds (P. 1056-1057) that a payment made to obtain the cancellation of a lease at the same time the land is purchased is not an allowable deduction under Section 23(a) of the Internal Revenue Code of 1939. While this conclusion may be proper in many instances, such as in *Herzberg* v. *Alexander*, 5 F. Supp. 334 and *Boos* v. *Commissioner of Internal Revenue*, 30 B. T. A. 882, it is not applicable to the facts in this proceeding.

Petitioner claims that the opinion of the Court does not consider the argument upon which the petitioner places great reliance and which may not have been adequately stressed in the original argument before this Honorable Court.

The decision of this Court, denying the deduction of $1,440,000, was based on the theory that the taxpayer had paid $2,100,000 for a "complete bundle of rights of land ownership" and the situation was the same "as if it had bought out the share of a co-owner or an over-riding easement, or, indeed, a piece of land next door." Such conclusion failed to give consideration to a basic tax principle not sufficiently stressed in the argument advanced to the Court that payments must be considered in accordance with the purpose for which paid in determining the tax consequences to the taxpayer.

Thus, in *Western Wine & Liquor Co.* v. *Commissioner*, 18 T. C. 1090, a wholesale liquor dealer purchased some shares of American Distilling Co., which was offering its shareholders the right to purchase whiskey inventory at cost. After exercising these rights, the taxpayer sold the stock at a loss. The Tax Court, emphasizing that the taxpayer purchased the distilling stock not as an investment in stock but only to acquire more whiskey to replenish its inventories in order to sustain its business, held that the difference between the cost of the American Distilling stock and the selling price represented additional cost of the whiskey acquired. Certainly the vendor of the American Distilling stock to the taxpayer was selling his entire interest in the stock and all the rights that accrued therein but the Tax Court did not bottom its decision on such fact but on the intent of the vendee-taxpayer. This decision was appealed by the Government to the U. S. Court of Appeals, Eighth Circuit, but the appeal was dismissed. 205 F. 2d 420. See

also, *Chas. A. Clark*, 19 T. C. 48; *Bagley & Sewell*, 20 T. C. 983.

This Court itself has recognized that principle in *Helvering v. Community Bond & Mortgage Corporation*, 74 F. 2d 727, and in *Roscoe v. Commissioner*, 215 F. 2d 478. (Not previously cited to the Court). While the latter case is the contra to that of the Millinery Center Building Corporation, the principle is the same. In that case two stockholders sold all of their holdings in a real estate corporation with which the corporation had an exclusive contract to sell the realty subdivision. The amount received for the stock was in excess of the actual value. The sale contract was for a unitary amount for the stock but as part of the contract the taxpayers agreed to cancel their agreement of exclusive agency. This Court upheld the Tax Court in taxing as ordinary income that part of the selling price in excess of the value of the stock. This Court said whether the excess amount represented compensation for services or payment for cancellation of an undesirable contract, it would be ordinary income. The important point is that the Court looked through the form of a unit price to get to the substance and sustained an allocation between the amount received for the actual value of the asset being sold and for services or cancellation of a contract.

This principle of having the intent of the purchaser govern the taxability of the transaction as well as allocating a single purchase price to the purposes for the payment has also been recognized in tangible property and real estate transactions. Thus, in *Olympia Harbor Lumber Co. v. Commissioner*, 30 B. T. A. 114, the petitioner paid $7,900 to acquire certain equipment owned by the vendor with a value not in excess of $2,500, and with the purchase of said equipment a contract between the petitioner and the vendor

was automatically terminated though not specifically stated. The difference of $5,400 was considered to be paid to rid the purchaser of an unsatisfactory contract and the deduction was allowed.

Similarly there is a line of cases dealing with the acquisition of the stock of a company in order to acquire real estate and other assets wherein it has been held that although the stock was what was actually acquired, and all the rights inherent therein, the intent was to acquire the assets and the amount paid for the stock was allocated to the real estate and other assets. Under this category would be the leading cases of *Prairie Oil & Gas Co.*, v. *Motter*, 66 F. 2d 307; *Commissioner* v. *Ashland Oil & Refining Co.*, 99 F. 2d 588; certiorari denied, 306 U. S. 661; *Kopper Coal Co.*, 6 T. C. 1209.

Farm land or orchard land is often bought and sold with the crop thereon for a single amount but allocations have been recognized by the Commissioner and, where not, certainly by the Courts.

With regard to the principle of merger; the decision of *Laird Bell* v. *Carter H. Harrison*, 212 F. 2d 253, is applicable. In that case a trust remainderman purchased the life interest of his parents and amortized the cost of the life estates over the life expectancy of his parents. The Commissioner disallowed the deduction for amortization, contending there was a merger of the two estates, particularly in view of the fact that the plaintiff evidenced no intent to preserve the two interests separate and distinct, and that in view of this merger the capital invested could be recouped only at the time of sale or other disposition by way of being added to the cost basis of such property. The Court of Appeals (Seventh Circuit), sustaining the taxpayer, dismissed this argument of merger or "bundle of rights".

The decisions referred to by the Court, *Post* v. *Commissioner* 109 F. 2d 135; *Herzberg* v. *Alexander*, D. C. W. D. Okla. 5 F. Supp. 334; and *Boos* v. *Commissioner*, 30 B. T. A. 882, are not in point in that each pertains either to a taxpayer who was already a fee owner or a taxpayer who had acquired the lease interest as an investment; whereas in the instant proceeding the Millinery Center Building Corp. already owned the building, had a lease on the land, enjoyed the income therefrom and did not have to make any current payment to acquire an investment in the lease.

In *Post* v. *Commissioner*, *supra*, the taxpayer was the owner of the land, who at the same time had a leasehold interest arising from the tenant's destruction of an old building on his property in order to put up a new one. A few years later, the tenant's interest was sold on foreclosure sale to a new company, all of whose stock and securities were received by the landlord, the landlord transferring his fee property to the new corporation. Here the landlord had not paid any amount to anyone and the accounting item of leasehold was merely transferred to the new company in exchange for the stock. There was no actual loss to deduct.

In *Herzberg* v. *Alexander*, *supra*, the taxpayer had purchased an unexpired lease for 8 years and 9 months of an original 10-year lease from the tenant for $5,000. In the next year the taxpayer purchased the land and building from the owners for a consideration of $63,500. Where a taxpayer pays the lessee a sum of money to take over a lease, it is obvious that the lease is not onerous but favorable to the tenant and less favorable to the landlord. Then, the property sold subject to a lease not favorable to a landlord would probably command less than the actual value of the land and building and the addition of the lease payment to the property cost would tend to compensate for this fact and give the fair market value.

To illustrate: property is leased at $10,000 per annum for a period of 20-years but after 5 years the rental value of the property increases to $20,000 per annum. Because of the favorable low rent of $10,000 per annum, the tenant could sell his leasehold interest for $50,000. The landlord, however, subject to the low rent of $10,000 instead of the fair rental value of $20,000 finds that based on land values surrounding his property, his land should be worth $300,000, but he can only receive $200,000 because of the unfavorable lease. Now, if the new lessee, who has paid $50,000 to acquire the leasehold interest, purchases the land for $200,000, it would obviously be unjust and improper to allow him to write off that $50,000. That $50,000 is more properly added to the $200,000 purchase price to arrive at the actual value of the property purchased.

That is not the case in the instant proceeding where the tenant pays a sum of money to save paying excessive rent as well as being relieved from other onerous lease terms and where proof has been submitted that the actual value of the land is much less than $2,100,000.

In *Boos* v. *Commissioner*, *supra*, the taxpayer in 1927 acquired, at a cost of $25,000, a 99-year lease with option to purchase, and in the very next year exercised the option and acquired the remainder interest. The facts in Boos indicate that the entire transaction can be considered one continuing transaction, making the taxpayer's cost the initial $25,000 and the $55,000 paid in the next year. Furthermore, when a taxpayer pays $25,000 to acquire a lease, it cannot very well argue that the lease was onerous and that the purchase of the property was to effect the cancellation of the lease.

In answer to the obvious question, why did the Millinery Center Building Corporation renew the lease in April 1945,

it is respectfully submitted to the Court that the petitioner had a building thereon of substantial value, with a remaining economic life of 50-years and assessed in excess of $2,100,000, which investment it desired to retain.

This Court raised the question of whether the lease was in fact onerous, although such fact or lack thereof was not determinative of the Court's decision. Petitioner respectfully points out that the Tax Court did find that "petitioner purchased the fee to be released from the terms of the lease. Petitioner was most concerned about the annual rental of $118,840, which it deemed excessive, and the contingent liability to remove the building from the premises at the expiration of the lease upon the request of the landlord." (A 8)

There was also undisputed expert and authoritative testimony that the fair rental value of the land was between $35,000 and $40,000 per annum in 1945, although the petitioner was paying $118,840. (R. 149, 168, 170).

It is not necessary to lose money for a lease to be onerous. When one is paying 2½ times the fair rental value, that in itself affords a basis for the taxpayer to pay a sum to cancel such a contract. (See *The Stuart Co. v. Commissioner*, Tax Court Memo. Opinion Docket 12413. Aff'd 195 F. 2d 176).

The Post, Herzberg and Boos cases may be further distinguished from the instant proceeding in that the principle expressed therein pertaining to minor interests becoming merged with major interests is not applicable here. According to the testimony at the Tax Court trial, the fair rental value for the land alone on which the Millinery Center Building was erected was between $35,000 and $40,000 per annum compared to the $118,840 being paid. The excess of rent to be paid for the next 21-years would be

more than $1,600,000. To save this very substantial amount, and further substantial amounts in the event the lease was renewed, the taxpayer bought a piece of land worth $660,000. The purpose of this transaction was the saving of at least $1,600,000 in rent, and not the acquisition of a piece of land worth $660,000, which the taxpayer did not have to acquire in the first instance to enjoy the continued use of the premises. The purchase of the land was only incidental to and the only means by which the taxpayer could cancel an onerous lease and still retain its equity in the building which was productive of income. The transaction was not primarily to acquire land which only secondarily and incidentally resulted in the cancellation of the lease.

The result of this Court's opinion may be demonstrated in the following illustration. Assume a third party, desiring to make an investment, buys land and building for $2,100,000. The purchaser would make an allocation between land and building and depreciate the building over the period of useful life. Now suppose the building was erected by a tenant who has a leasehold running for 42 years. The purchaser would then be buying land and leasehold, which leasehold would be amortizable over the 42-year period, in accordance with decision of *Mary Young Moore* v. *Commissioner*, 207 F. 2d 265. Now, assume that the tenant of the leasehold wishes to do what the third party did and purchase the property for $2,100,000. Since he already has the lease he will not be acquiring a leasehold and since the lease is for a longer period of time than the life of the building, he may not be acquiring a reversionary interest in the building and therefore must be paying $2,100,000 for the land alone, even though the land is only worth $660,000. Following this argument further, the land, which is only worth $660,000 when an outsider buys it for an investment,

suddenly becomes worth $2,100,000 when the leasehold tenant acquires it.

This Court, in its opinion, inferred that the value to be attributed to the land might be more than the $600,000 found by the Tax Court for the land unimproved. This Court stated: "That appraisal cannot be considered as conclusive of its (land) present value, improved by a $3,000,000 building appurtenant thereto."

Petitioner respectfully points out that any value attributed to the land because of a building erected thereon makes the land a wasting asset, which is not contemplated by the Internal Revenue Code. There is no question that the building will eventually be of no economic value and therefore the land some day will be worth only the value of the land without any offsetting value for a building. To attribute an increased value to the land because of such a condition and not permit depreciation thereon means a taxpayer has a wasting asset, concurrent with the depreciation of the building which is not going to be recovered taxwise. This is contrary to every accounting principle and to the very meaning of Section 23(l) of the Internal Revenue Code of 1939 and the Regulations promulgated thereunder.

In *Commissioner* v. *Starr Brothers*, 204 F. 2d 673, this Court held that an amount received by a dealer from a drug manufacturer in exchange for releasing the manufacturer from its contract obligation not to sell other dealers was ordinary income and did not constitute the sale of a capital asset. The Court agreed the taxpayer's rights were undoubtedly property but held the *termination of a contract is not a sale or exchange*. The property rights were not transferred, they merely came to an end and vanished. This case applied to the Millinery Center Building Corporation proceeding makes the answer clear—there were no property rights acquired by the Millinery Center Building Corpora-

tion in the cancellation of the lease. Whatever property rights to the excessive rent existed were not transferred as if to a third party purchaser but "merely came to an end and vanished." There was no "bundle of rights" to the Millinery Center Building Corporation and the amount paid to secure such vanishment was an ordinary and necessary expense and an allowable deduction.

It is stressed before the Court that the deduction of $1,400,000 or any part thereof does not result in a net tax loss to the Treasury but only compensates in part for the additional tax that is going to be paid by the petitioner in each year for at least the next 21 years. The petitioner's returns for 1945 and ensuing years no longer reflect the deduction of rent expense of $118,840. Its land investment entitles it to a saving in rent from $35,000 to $40,000 per annum, but the balance of approximately $80,000 the taxpayer is saving because it incurred the expense of $1,440,000, and it is paying tax on such $80,000 each and every year without any offsetting deduction, and at the end of 30-years it will have a land asset of only $660,000. This is an unconscionable deprivation of capital of this taxpayer.

Petitioner therefore respectfully requests a rehearing upon these points at the Court's convenience. Should further oral argument be deemed impractical, petitioner requests that consideration be given to the points set forth herein.

Respectfully submitted,

BERNARD WEISS,
Counsel for Petitioner on Review,
136 East 57th Street,
New York 22, N. Y.

April , 1955.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 127—OCTOBER TERM, 1954

MILLINERY CENTER BUILDING CORPORATION, *Petitioner*, v. COMMISSIONER OF INTERNAL REVENUE, *Respondent*.	Docket No. 23150

CERTIFICATE OF COUNSEL

I, Bernard Weiss, do hereby certify that I am Counsel of Record for petitioner on review in the above entitled proceeding; that the foregoing petition for rehearing is presented in good faith and not for the purpose of delay or vexation, and that in my opinion it is well founded in law and fact and proper to be presented to the Court.

.....

BERNARD WEISS,
Counsel for Petitioner on Review

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

MILLINERY CENTER BUILDING CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Before CLARK, Chief Judge, FRANK, Circuit Judge, and GALSTON, District Judge.

On Petition for Rehearing.

Bernard Weiss, New York City,
for Petitioner on Review.

PER CURIAM.

Petition for rehearing denied.

C. E. C.
I. N. F.
U. S. C. JJ
C. G. G.
U. S. D. J.

Filed May 18, 1955

APPENDIX B

CLEVELAND ALLERTON HOTEL, INC. v. COMMISSIONER OF INTERNAL REVENUE

No. 10558

CIRCUIT COURT OF APPEALS, SIXTH CIRCUIT.

March 22, 1948

1. Internal Revenue—234

Generally, "capital assets" for income tax purposes, consist of property devoted to production of income and may consist of intangibles such as franchises, good will and the like.

2. Internal Revenue—121

Taxation is a practical matter and taxing authority may look through form to substance.

3. Internal Revenue—551, 574.

Where lessee owning and operating hotel building on leased premises purchased fee from lessor for a price greater than value of land in order to escape from a burdensome lease, lessee was entitled to deduct difference between price paid and amount which evidence established was value of the land, as an expense of doing business in the year when made, though no such separation of consideration was made in the purchase transaction.

Petition to Review a Decision of the Tax Court of the United States.

Petition by the Cleveland Allerton Hotel, Inc. to review a decision of the Tax Court redetermining deficiencies in income taxes assessed by the Commissioner of Internal Revenue.

Reversed and remanded.

M. R. Schlesinger, of Cleveland (M. R. Schlesinger, of Cleveland, on the brief; Horwitz, Kiefer & Harmel, of Cleveland, of counsel), for petitioner.

Louise Foster, of Washington (Theron L. Caudle, Sewall Key, George A. Stinson and Louise Foster, all of Washington, D. C., on the brief), for respondent.

Before HICKS, SIMONS and MILLER, Circuit Judges.

SIMONS, Circuit Judge.

The tax problem posed by the present appeal is one for the solution of which there is no precedent. It is clearly a case of first impression, and involves the question whether a lessee in possession, owning and operating a hotel building on leased premises, who purchases the fee from the lessor for a price greater than the value of the land, may allocate a portion of the purchase price to the purchase of the unexpired lease either by deducting the allocated portion as a business expense in the year of purchase or depreciate it over the term of the lease or the anticipated useful life of the hotel building. The Tax Court decided that the petitioner could do none of these things, and the taxpayer seeks review.

The case involves tax liability for 1941 and 1942. Deficiencies were asserted for such years by the respondent. In 1941, the petitioner was the owner of a 16-story brick and steel hotel in Cleveland, built upon leased ground. With details of its acquiring possession, we are not presently concerned. The lease had an unexpired term of 80 and a fraction years, and the ground rent was $25,000 a year. The petitioner concluded that its rent was excessive by at least $15,000 a year, and that ultimately it might lose its building, if it found no escape from the obligation. After

negotiating with the owners of the fee, it submitted a written offer to purchase the fee for the sum of $441,250 in cash, and the offer was accepted in writing by the owner of the land. On March 19, 1941 the purchase was consummated by payment of the money and the delivery to petitioner of the lessor's deed, which not only conveyed title to the real estate, but recited that the lease and the estate thereby created should merge in the title, the grantor acknowledging that all of the covenants, provisions, and conditions of the lease had been fully performed.

The petitioner in its tax returns for the tax years sought a deduction in substantial amount for part of the purchase price, on the ground that it was paid, not for the real estate but to be relieved of an improvident rental obligation, that consideration for the release could accurately be measured by the difference between the fair value of the real estate and what it was obliged to pay therefor, and that such amount was an expense of doing business. It here contends that the deduction was allowable in full in 1941, or in the alternative that it should be permitted to amortize it either over the term of the lease or the anticipated useful life of the building. The respondent contends that the deduction may not be granted in either form and the Tax Court agrees.

The petitioner argues that its primary purpose was to buy its way out of that portion of its leasehold obligation which was excessive and that its purchase of the fee was merely incidental to that purpose. It could not, it says, have merely secured escape from a burdensome lease and leave the premises because it owned a valuable building thereon. It had no need for the fee simple title because it already had full possession and use of the land by the provisions of the lease for its unexpired term. Uncontradicted testimony supports the petitioner's assertion of its pur-

pose and the necessity for buying the land to escape from the lease. Its claim that the value of the land was no more than $200,000 is supported by credible and uncontradicted evidence, which the Tax Court finds establishes that if there were no lease to be considered the value of the land would be $200,000. The petitioner concedes that neither in the negotiations to purchase nor in the contract which eventuated, was there any designation of consideration separately assignable to the purchase of the leasehold or to the reversionary interest in the land, but urges that such allocation has no bearing on the problem for if the transaction is to be viewed realistically, what it paid over and above the fair value of the real estate must necessarily have been paid to escape an excessive rental obligation. The respondent argues that the price of all land is almost wholly determined by the amount prospective purchasers will receive through its ownership and use, that the land in 1941, by reason of a very profitable lease, secured by the hotel building, was a capital asset, which either to the lessee or to other prospective purchasers would fully support the price that was paid for it. He reasoned that a prospective owner in April 1941, whether taxpayer or third party, would annually produce from the land $25,000, and that the capitalization of this return at an acceptable interest rate controls the value of the land. He also relies on the fact that there was no allocation of the purchase price separately to land or lease, so that there is no basis for the allowance of a deduction either by treating any part of it as 1941 expense, or by amortizing it over the term of the lease or the useful life of the hotel building.

(1) As purely legalistic formalism, this argumentation bears an aura of validity. Realistically considered, however, it will not stand analysis. The status of the petitioner does not approximate that of a third person investor,

buying real estate to which is appurtenant a long-term profitable lease. The petitioner already had the use of the land with full control and dominion over it, subject only to its obligation to surrender it at the end of the term. The lease was a liability which it sought to extinguish. This it was impossible to do merely by buying acquittance and giving up possession of the premises. It had thereupon a valuable hotel building which it could not take away with it. The only interest in the land it secured by the purchase that it did not already have was the reversionary interest, which all parties appear to consider as of only nominal value. To consider that remainder a capital asset with a value of $441,250 requires, it seems to us, a naivete not attributable to experienced and sophisticated taxing authority. The usual conception of capital assets is that of property devoted to the production of income. True, it may not always consist of concrete things, as for instance in the case of franchises, good will and the like, but funds expended by way of liquidated damages for release from contract do not ordinarily buy capital assets.

(2) If numerous admonitions that taxation is a practical matter, that taxing authority may look through form to substance, is not mere rhetoric where the taxpayer's interest is involved, and a working formula only when it is of advantage to the Treasury, it would seem to be clear that the petitioner paid all over $200,000 to escape from a burdensome lease, and should be able to write that off as an expense of doing business.

A second ground for the Tax Court decision was that it was unable from the facts of the case to allocate any portion of the purchase price of the land involved to release from the lease, and so was unable to find any basis for a depreciation deduction. But the Court had found it to be established that the land without the lease had a value of

$200,000. The rest we think would be simple arithmetic. In determining a base for depreciation of improved property purchased without allocation of consideration to buildings as distinguished from real estate, there has never been any difficulty in determining the value of the improvements, nor of the value of improvements as income to the lessor where a lease is subsequently cancelled or forfeited; nor of a base for obsolescence of leasehold interests, or of mineral rights not valued separately from the fee. Cf. Limericks, Inc., v. Commissioner, 5 Cir., 165 F. 2d 483.

(3.) While the petitioner's evidence may have suggested the view that it was entitled to deduct the whole purchase price, with interest in the reversion treated as negligible, it now seems perfectly clear that the petitioner's position is that only that part of the consideration which it paid for the deed over and above $200,000 should be allocated as an expense paid to escape its rental obligation under the lease. This being so, we find ourselves in accord with the decision of the Third Circuit in Cassatt v. Commissioner, 3 Cir., 137 F. 2d 745, and with the decision of the Board of Tax Appeals in Appeal of Denholm & McKay Co., 2 B. T. A. 444, that payments of this character must be deducted on the taxpayer's tax return as an expense of doing business in the year when made. The reason set forth in the Cassatt case is that such payment is not prepayment of rent to secure future tenure, but is in consideration of cancellation (or surrender) and so in the nature of damages to secure relief from unprofitable contracts. This being our view, it is unnecessary to consider the petitioner's alternative contention in respect to the amortization of its original rental obligation over the term of the lease or the anticipated useful life of the hotel building.

Reversed and remanded to the Tax Court for such further proceedings consistent herewith.

BRIEF ON MERITS
No. 255

IN THE

Supreme Court of the United States

OCTOBER TERM 1955

MILLINERY CENTER BUILDING CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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IN THE

Supreme Court of the United States

OCTOBER TERM 1955

MILLINERY CENTER BUILDING CORPORATION,

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

Opinion Below

The opinion of the Court of Appeals (R. 16-19) rendered April 14, 1944, is reported at 221 F. 2d 322. The Findings of Fact and Opinion of the Tax Court of the United States, promulgated February 26, 1954, are reported at 21 T. C. 817 (R. 1-15). Judgment was entered March 22, 1954.

Jurisdiction

The judgment of the Court of Appeals for the Second Circuit is dated April 14, 1955 (R. 20). The timely peti-

tion for rehearing to the court below was denied on May 18, 1955. (R. 28). Petition for a writ of certiorari to this court was filed on July 22, 1955 and was granted on October 10, 1955. The jurisdiction of this Court rests on 28 U. S. Code, Section 1254(1). See Rule 19(1)(b).

Questions Presented

1. Where a lessee, the owner of a valuable building on leased land, acquires the fee to the land to be relieved of what it considers to be the burdensome terms of a lease, may the lessee deduct the excess of the payment over the determined value of the land at the date of purchase as an ordinary expense of doing business under Section 23(a) of the U. S. Internal Revenue Code of 1939 or under Section 23(f) as a loss on a transaction entered into for profit and not compensated for by insurance or otherwise?

2. In the alternative, may the lessee-petitioner consider the excess payment over the determined value of the land to be in the nature of a prepayment of rent for the remaining term of the extinguished lease and amortize such amount over 21 years?

Statutes Involved

Pertinent provisions of the U. S. Internal Revenue Code of 1939, adopted by Act of February 10, 1939, Ch. 2, 53 Stat. 1-504 (as amended by Section 121 of the Revenue Act of 1942, Ch. 619, 56 Stat. 798), applicable to this proceeding are:

"Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.

(1) Trade or business expenses.

(a) In general. All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

"Sec. 23(f) Losses by Corporations.

In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise."

"Sec. 23(l) Depreciation. A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)

(1) of property used in the trade or business, or

(2) of property held for the production of income."

"Sec. 272. Procedure in General.

(a)(1) Petition to the Tax Court of the United States.

If in the case of any taxpayer, the Commissioner determines that there is a deficiency in respect to the tax imposed by this chapter, the Commissioner is authorized to send notice of such deficiency to the taxpayer by registered mail. Within ninety days after such notice is mailed (not counting Saturday, Sunday or a legal holiday in the District of Columbia as the ninetieth day) the taxpayer may file a petition with the Tax Court of the United States for a redetermination of the deficiency.***"

* * * * * *

(26 U. S. Code 1952 Ed.)

Statement

The petitioner duly filed its petition for a redetermination of its excess profits tax liability for the calendar year 1945 with the Tax Court of the United States which had jurisdiction over the proceeding in the first instance, in accordance with Section 272(a)(1) of the U. S. Internal Revenue Code of 1939.

The Tax Court of the United States made its findings of fact and rendered its opinion on February 26, 1954 and entered its decision on March 22, 1954, on the basis of the pleadings, oral testimony, arguments and briefs (R. 1-16).

It was determined by the Tax Court of the United States that the lessee-petitioner (the owner of the building on leased land) was not entitled to deduct any part of a payment made by the petitioner to the owner of the land over and above the determined value of the land at the date of purchase of the fee in 1945 to obtain the cancellation of a lease, the rental terms of which were deemed by the petitioner to be excessive; that the payment of $2,100,000 was made by the petitioner for a "bundle of rights", no part of which was amortizable over the remaining term of the extinguished lease or depreciable over the remaining economic life of the building.

The Tax Court of the United States was sustained by the court below in its holding that the excess payment over the determined value of the land of $600,000 was a capital asset which could neither be deducted as an expense or a loss nor could any part of the payment to the landowner be amortized (R. 17-19); but the Circuit Court below agreed with the six dissenting judges of the Tax Court of the United States that the petitioner had made an additional investment in the building which it had a right to depreciate over the remaining economic life of the building (R. 19).

With regard to this latter holding of the court below, the respondent in his memorandum (R. M. 6; 7) states:

> "It is to be observed, however, that the taxpayer prevailed on the third question stated in its petition (Pet. 2)—i.e., it was allowed by the Court of Appeals to depreciate the value of the building over its remaining economic life—and we do not seek review of this determination. Since there is thus no issue here as to the correctness of the decision below on this question, there is no occasion for this Court to reach and review it."

The decision of the Tax Court of the United States was based on the following findings of fact:

On April 30, 1924, petitioner leased land at the northeast corner of Seventh Avenue and 38th Street, New York City, from the landowner. The plot was approximately 100 feet on Seventh Avenue and 200 feet on 38th Street (R. 4).

The lease provided that the petitioner-lessee was to build a 22-story loft building at a cost of $3,000,000, including interest, taxes and insurance during construction on said leased land (R. 4).

Petitioner had to pay a net basic ground rental of $100,000 per annum plus the income taxes thereon (R. 4).

Title to the building, including improvements, additions and fixtures belonged to the petitioner-lessee. Title to the building was to vest in the landlord at the expiration of the last term of the lease, or other sooner termination thereof, at the option of the landlord (R. 4).

In the event of the destruction of the building by fire or other causes, tenant was still liable on the lease and could not abandon the lease (R. 4).

In the event of the destruction, in whole or in part, of the building, the tenant at its own cost had to make the building whole. At the expiration of the lease, or the sooner termination thereof, the petitioner-tenant was to surrender the premises and the building to the landlord at his option, free and clear of any encumbrances, without the landlord being obligated to pay for the property (R. 4).

Petitioner had the option to renew the lease for two successive terms of 21 years each. The ground rent

for the renewal period was to be 6% of the value of the land, vacant and unimproved, at the termination of each period of the lease, but in no event was the rent to be less than the basic net rent of $100,000 plus $18,840 which represents the additional rent in lieu of income tax on such $100,000 (R. 5).

On April 16, 1945, petitioner renewed the ground lease for an additional 21 years. The parties to the lease agreed, and the Tax Court found, that the rental at 6% of the value of the land in April 1945 would have been less than the minimum basic net rental of $100,000 (R. 5).

On May 11, 1945, petitioner purchased the fee and obtained release from the obligations of the renewed lease for $2,100,000. Petitioner purchased the fee to be released from the terms of the lease. Petitioner was most concerned about the annual rental of $118,840, which it deemed excessive, and the contingent liability to remove the building from the premises at the expiration of the lease at the request of the landlord (R. 5).

The agreement of sale between the Wendel Foundation, lessor and owner of the fee, and petitioner recited among other provisions the price was $2,100,000 and seller shall execute upon request of the purchaser (petitioner) an agreement cancelling and terminating said lease as of the time of the actual closing of title hereunder (R. 5, 6).

The value of the land, vacant and unimproved, upon which the petitioner's property stood was $660,000 when purchased by petitioner in 1945 (R. 8).

Other facts are:

The fair net rental value of the land at the date of purchase in 1945 was between $35,000 and $40,000 per annum (R. 50, 56).

The rental prices of the land in 1924 was 2-1/2 times the values in 1945, the year of the purchase of the property (R. 55).

The original building cost of approximately $3,000,000 was amortized by petitioner over the first 21-year term of the lease which fact is not at issue in this proceeding (R. 14).

ARGUMENT

I.

THE PETITIONER-LESSEE IS ENTITLED TO DEDUCT $1,440,000 OR SOME PART THEREOF INCURRED IN CONNECTION WITH THE CANCELLATION OF A BURDENSOME LEASE AS AN ORDINARY AND NECESSARY EXPENSE UNDER SECTION 23(a) OR AS A LOSS UNDER SECTION 23(f) OF THE U. S. INTERNAL REVENUE CODE OF 1939.

There is no question that the motivating factor for the taxpayer's expenditure of $2,100,000 was to be released from what it deemed to be the burdensome terms of a lease reflected in excessive rent and contingent liabilities that could very well become onerous. Simonson, petitioner's president, made this clear in his testimony (R. 45, 46).

Although this fact was recognized by the Tax Court (R. 5) and it determined from competent and authoritative evidence that the value of the land, vacant and unimproved, was $660,000 in May 1945, it refused to allow any deduction for the excess payment of $1,440,000

($2,100,000 over $660,000). The Tax Court treated the whole transaction as the purchase of a bundle of rights, a capital asset, for which no allocation was possible. The Tax Court did not define what was included in this bundle of rights other than that the bundle included the cancellation of the lease.

The Circuit Court below agreed with the conclusion of the Tax Court that no deduction under Section 23(a) of the U. S. Internal Revenue Code of 1939 was allowable but held the bundle of rights consisted of a reversionary interest in land and building.

The petitioner contends that it bought nothing more for its $2,100,000 than land worth $660,000 and a cancellation of a lease. There were no other rights in the "bundle". Its rights to the actual use and enjoyment of the property under the lease were as complete and as beneficial as after the purchase of the fee. What the petitioner did was to extinguish a number of contingent liabilities and a real liability to pay rent of $118,840 per annum, of which a minimum of $78,000 was excessive. There is no question that petitioner's income was thereafter increased by $118,840 per annum and it is paying income taxes thereon each year.

The Tax Court in support of its findings that petitioner was not entitled to any deduction stated that the bundle of rights was so inextricably entwined in the acquisition of the land that no segregation could be made between the value attributable to the land and the value attributable to the cost of cancelling the lease. The conclusion of the Tax Court was apparently influenced to some extent by the failure of the contract of sale to state separately what

amount was being paid for the land and what amount for the cancellation of the lease. The Tax Court ignored what it should have judicially noted that in practically every case when improved real estate is sold, there is no segregation between the value attributable to land and value attributable to other assets. The courts have recognized that for tax purposes a single payment may include an amount for the purchase of an asset and the payment of an expense, and if the expense is ordinarily a deductible item, the fact that it was included in an aggregate transaction will not affect its allowance. *Lomas & Nettleton Co. v. U. S.*, 79 F. Supp. 886 (D. Conn. 1948); *The Stuart Co. v. Commissioner*, Memo T. C. Op. Docket 12473, Aff'd (C. A. 9, 1952) 195 F. 2d 170; *Cleveland Allerton Hotel, Inc. v. Commissioner*, 166 F. 2d 805 (C. A. 6, 1948).

The error of the Tax Court and the court below in refusing to allow the payment of $1,440,000 as a deduction was due to their failure to recognize that the right to excess ground rents is a property right, separate and apart from the land itself. However, in a recent decision of *Mary Young Moore v. Commissioner*, August 5, 1955, the Tax Court, upon remand of the case from the U. S. Court of Appeals, 207 F. 2d 265 (C. A. 9, 1953), recognized for the first time that a total value for land and leasehold may be broken up into its component parts. In that case the inherited value of a fee estate subject to a long-term lease was determined to be in excess of the basic land value. The U. S. Court of Appeals, Ninth Circuit, in a well reasoned opinion held that the taxpayer's right to receive rents based on 1924 values, the date the lease was negotiated, which were in excess of rent values when the fee was ac-

quired, was a property right which should be amortized over the period the excess rentals would be received.

The economic sameness of this opinion is manifest in the following illustration. Assume F. W. Woolworth Co. is the tenant under a long-term leasehold with 10 years still to run, calling for an annual rent of $50,000. Further, assume the neighborhood has so changed since the lease was negotiated that the area is no longer profitable—even a ghost area. The basic land value at current market prices is only $60,000 but because of future aggregate rental income of $500,000 for the ensuing 10-year period, the land can be sold for $400,000. Such a purchaser is buying a financial transaction and not just land. To properly reflect the economics of the transaction, he should and would allocate $60,000 to land and $340,000 to leasehold (arising from future excess rental income) and amortize said $340,000 over a 10-year period. Thus, his net annual income would be $16,000 ($50,000 rent less $34,000 amortization) on a true land investment of $60,000, and a total average investment of $230,000 ($60,000 + ½ of $340,000). If the total price of $400,000 were considered land, the purchaser would be paying taxes on $50,000 income each year and at the end of 10-year term, when the lease expired and no tenant was available, he would have a piece of property worth only $60,000 with a cost basis of $400,000 and no income to offset the loss against. Certainly, such a result is not in accord with the realities of the situation.

It is probably this reasoning which led the Circuit Court in *Mary Young Moore v. Commissioner, supra*, to hold:

> "The lease, or rather the portion thereof providing the above normal rents, is an intangible asset with a definitely limited life * * *

> * * * if taxpayer could prove, the extent to which the lease was 'favorable', or, what part of the rents are above normal, it should be feasible to ascertain the amount of the purchase price which represented a premium for the favorable aspects of the lease. Such would be no more difficult than the ascertainment of the proper basis for depreciation in the ordinary case where a purchaser buys a lot with a building thereon, all for a lump sum."

Upon remand, the Tax Court (Docket Nos. 17207 & 19383) did determine a value for the excess rentals and permitted the taxpayer to amortize said value over the remaining life of the lease.

The Supreme Court itself, in *Hort* v. *Commissioner of Internal Revenue* (1941), 313 U. S. 28, has recognized that it is possible to value realty and leasehold (arising from excess rentals) separately, when it stated "it might have been possible in such a case to value realty and lease separately and to label each a capital asset."

The position of the petitioner in this proceeding is the contra to that of a purchaser of land with an unduly favorable lease or excess rentals. It follows that what is an unduly favorable lease from excess rents and thus an asset to recipient of the rents must be an unfavorable or burdensome lease and a detriment to the lessee caught on the terms of said lease negotiated many years before under different economic circumstances. The purchaser of land with such a lease thereon is going to reap an advantage over the term of the lease and thus should capitalize this advantage (an intangible property right) and amortize it over the period of the lease. However, a lessee, as in the instant proceeding, buying the land is not acquiring any future

rent income; he is getting out from under an excessive obligation, a definite business purpose, and should be entitled to deduct an expenditure for such a purpose as an ordinary and necessary business expense in the year incurred.

This petitioner should not be treated the same as a person who never had an interest in the property and first acquired land subject to a leasehold. Prior to this purchase in 1945, the taxpayer had invested $3,000,000 in improvements. Any outsider purchasing the interest of the landowner in 1945 would not have had such prior investment in the property. This petitioner had the right to receive all the rents from the property subject only to its obligation to pay operating expenses and the ground rent of $118,840. An outsider acquiring the landowner's interest would not have had the right to collect the rents from the improvement nor would he be obligated to pay the $118,840 net ground rent.

The fact that petitioner had renewed its lease shortly before buying the fee does not establish the fairness of the rent being paid or the value of the land to petitioner. Petitioner had to renew at the excessive rent in order to sustain its economic rights to the leasehold, which were substantial. The building which petitioner owned, costing three million dollars, had a remaining economic life of 30-years and it was not possible for petitioner to take it away. That the rent was excessive in 1945 was testified to at the Tax Court hearing by most competent and creditable witnesses. (R. 47-56). No contrary evidence on that point was introduced by respondent. In fact, the petitioner and its landlord when renewing the lease in 1945, agreed that no appraisal of the land in 1945 (upon which appraisal the net annual rent was to be based at a 6% value) need be made since such a com-

puted rent would be less than the minimum guaranteed basic net rent of $100,000 per annum. (R. 5.)

The U. S. Court of Appeals, Sixth Circuit, had a similar question before it in *Cleveland-Allerton Hotel, Inc. v. Commissioner of Internal Revenue, supra,* and recognizing that taxation is a practicable matter, went to the essence of the transaction and sustained the taxpayer. See also *The Stuart Co. v. Commissioner,* Memo T. C. Op. Docket 12473, aff'd 195 F. 2d 176 (C. A. 9, 1952) in which the courts permitted the taxpayer to allocate a lump sum payment in part to the purchase of trademark and copyrights and in part to the cancellation of an unfavorable supply contract from the same vendor, and allowed a deduction under Section 23(a) of the Internal Revenue Code of 1939 for the amount allocated to the cancellation of the contract.

In *Hort v. Commissioner of Internal Revenue* (1941), 313 U. S. 28, a landlord received a sum of money from a tenant who found it unprofitable to occupy the premises and desired to cancel the lease, which had approximately 14 years more to run. In reviewing the facts and the issues involved, the Supreme Court concluded that the taxpayer had to report as income the entire amount received for the cancellation of the lease since the cancellation involved nothing more than the relinquishment of the right to future rental payments in return for a present substitute payment and possession of leased premises. The Court recognized that the taxpayer's rental income would be less in the future but pointed out that to that extent the taxpayer was relieved of the duty to pay income taxes.

The position of the Millinery Center Building Corp. in the instant case is the converse of that of the taxpayer Hort. It is in the position of the tenant who has made the

payment to save the rental expense, will be paying additional income taxes on the increased income effected by such savings in rent, and should be allowed a deduction for the payment to cancel the lease. Although land was acquired at the same time, it is being paid for at full value in the amount of $660,000.

A contributing factor to the error in the opinions of both courts below was their disregard of a basic principle that the tax consequences of any transaction must be determined from the view of the particular taxpayer entering into the transaction. Thus, in *Western Wine & Liquor Co. v. Commissioner*, 18 T. C. 1090, a wholesale liquor dealer purchased some shares of American Distilling Co. which was offering its shareholders the right to purchase whiskey inventory at cost. After exercising these rights, the taxpayer sold the stock at a loss. The Tax Court, emphasizing that the taxpayer purchased the American Distilling Co. stock not as an investment in stock but only to acquire more whiskey to replenish its inventories in order to sustain its business, held that the difference between the cost of the stock and the selling price represented additional cost of the whiskey acquired. Certainly the vendor of the American Distilling Co. stock was selling his entire interest in the stock and all the rights that accrued therein to the taxpayer but, the Tax Court did not bottom its decision on such fact but on the intent of the vendee taxpayer. An appeal from this decision to the U. S. Court of Appeals, Eighth Circuit, was dismissed, 205 F. 2d 420. To the same effect are the decisions of *Bagley & Sewall*, 20 T. C. 983, aff'd 221 F. 3d 944 (C. A. 2, 1955); *Helvering v. Community Bond & Mortgage Corporation*, 74 F. 2d 727, (C. A. 2, 1935); *Roscoe v. Commissioner*, 215 F. 2d 478, (C. A. 2, 1954). While

the latter case is the contra to that of the petitioner, the principle is the same. In that case two stockholders sold all their holdings in a real estate corporation with which the corporation's stockholders had an exclusive contract to sell the real estate subdivision. The amount received for the stock was in excess of the actual value of the real estate. While the sale contract was for a unitary amount, the taxpayers agreed as part of the contract to cancel their agreement of exclusive agency. The Circuit Court upheld the Tax Court in taxing as ordinary income that part of the selling price in excess of the value of the stock. The Court was of the opinion that whether the excess amount represented compensation for services or payment for cancellation of an undesirable contract it would be ordinary income to the recipient. Thus the Court looked through the form of the unit sales price to get to the substance and sustained an allocation between the amount received for the actual value of the asset being sold and for services or cancellation of the contract.

This principle of determining the taxability of transactions from the intent of the particular taxpayer entering into the transaction has also been recognized in tangible property and real estate transactions. Thus, in *Olympia Harbor Lumber Co.* v. *Commissioner*, 30 B. T. A. 114 (1934), the taxpayer paid $7,900 to acquire certain equipment owned by the vendor with a value not in excess of $2,500, and with the purchase of said equipment a contract between the taxpayer and the vendor was automatically terminated though not specifically stated. The difference of $5,400 was considered to be paid to rid the purchaser of an unsatisfactory contract and the deduction was allowed.

Similarly, there is a line of cases dealing with the acquisition of the stock of a company in order to acquire real estate and other assets, holding that although the stock was what was actually acquired, and all the rights inherent thereto, the intent was to acquire the assets behind the stock and the amount paid for the stock was allocated to the real estate and other assets. In this category are the leading cases of *Prairie Oil & Gas Co.* v. *Motter*, 66 F. 2d 309, (C. A. 10, 1933); *Commissioner* v. *Ashland Oil & Refining Co.*, 99 F. 2d 588 (C. A. 6, 1938); Cert. Den. 306 U. S. 661.

The court below in failing to recognize that the value of excess rentals, based upon economic conditions no longer prevailing, may be apart from actual current land values, and that the intent of a taxpayer is the very core of the substance of a transaction, determined that the Millinery Center Building Corporation had merely acquired the equivalent of the "share of a co-owner or an over-riding easement, or a piece of land next door." In support of this opinion, the court below cited the cases of *Post* v. *Commissioner*, 109 F. 2d 135 (C. A. 2, 1940); *Herzberg* v. *Alexander*, D. C. W. D. Okla. 5 F. Supp. 334 (1933) and *Boos* v. *Commissioner*, 30 B. T. A. 882 (1934).

These decisions referred to by the court below are not in point in that each pertains either to a taxpayer who was already a fee owner or a taxpayer who had acquired the lease interest as an investment; whereas, in the instant proceeding, the Millinery Center Building Corporation already owned the building, had a lease on the land, enjoyed the income therefrom and did not have to make any current payment to acquire an investment in the lease.

In *Post* v. *Commissioner*, supra, the taxpayer was the owner of the land, who at the same time had a leasehold interest arising from the tenant's destruction of an old

building on his property in order to put up a new one. A few years later the tenant's interest was sold on foreclosure to a new company, all of whose stock and securities were received by the landlord, the landlord transferring his fee property to the new corporation. Here the landlord had not paid any amount to anyone and the accounting item of leasehold together with the land were merely transferred to the new company in exchange for the stock. There was no actual loss to deduct.

In *Herzberg* v. *Alexander*, supra, the taxpayer had purchased the unexpired lease for 8 years and 9 months of an original 10-year lease from the tenant for $5,000. In the *very next year*, the taxpayer purchased the land and building from the owners for $63,500. Where a taxpayer pays a lessee a sum of money to take over a lease and within a short period of time acquires the fee, it is obvious that the lease is not burdensome but favorable to the tenant. Then the property, sold subject to a lease favorable to the tenant and consequently less favorable to the landlord, would probably command less than the actual value of land and building and the addition of the lease payment to the property cost would tend to compensate for this fact and give the fair market value.

To illustrate: property is leased at $10,000 per annum for a period of 20 years but after 5 years the rental value of the property increased to $20,000 per annum. Because of the favorable low rent of $10,000 per annum, the tenant could sell his leasehold interest for $100,000. The landlord, however, subject to the low rent of $10,000 per annum, instead of the fair rental value of $20,000, finds that he can only receive $200,000 for his land because of the un-

favorable lease, rather than the $300,000 his land is worth based on land values surrounding his property. Now, if the new lessee, who has paid $100,000 to acquire the leasehold interest, purchases the land for $200,000, it would obviously be unjust and improper to allow him to write off that $100,000. That $100,000 is more properly added to the $200,000 purchase price to arrive at the actual value of the property purchased.

That is not the case in the instant proceeding where the tenant paid a sum of money to save paying excessive rent as well as being relieved from other onerous lease terms and where the Tax Court has found as a fact that the actual value of the land is only $660,000 instead of $2,100,000 paid.

In *Boos v. Commissioner*, supra, the taxpayer in 1927 acquired, at a cost of $25,000, a 99-year lease with *option to purchase*, and in the *very next year* exercised the option and acquired the remaining interest. The facts in *Boos* indicate that the entire transaction can be considered one continuing transaction, making the taxpayer's cost the initial $25,000 and the $55,000 paid in the next year. Furthermore, when a taxpayer pays $25,000 to acquire a lease, it cannot very well argue that the lease was burdensome and the purchase of the property within a year, under the option, was to effect the cancellation of the lease.

The error of the court below is further evident when its decision is put to the test of practical application. That court said that what petitioner bought was a reversionary interest in land as well as building. Petitioner's lease had 21 years to run and the present value of a reversionary interest in land (21 years later) which land is currently

worth $660,000, would not be in excess of $200,000, allowing for a 6% discount rate. This would leave a $1,900,000 present value for a reversionary interest 21 years later of a building which would then have only a 9-year remaining life—a result hardly in accord with the economic facts.

If the renewed lease had been for a period of 42 years (balance of the term under the original lease) there would be no reversionary value for a building with a remaining life of 30 years. Then, land, vacant and unimproved with a present value of $660,000, would, by the force of arithmetic, suddenly have a reversionary value (42 years off) of $2,100,000 under the decision of the court below. The difference in value could not be attributed to the building thereon for that would be of no value, the economic life being 30 years. As a matter of fact, a reversionary interest is obviously worth less than a current whole interest, which the Tax Court conclusively found to be $660,000 for the land. There can be no doubt that the decision of the court below is not in accord with the realities of the situation.

Further illustrating the incongruities arising from the Circuit Court's decision is the following:

> For simplication, let us assume an equal life of lease and building (eliminating the arithmetic of a 9-year overlap in building value). A third party purchaser of the land subject to the lease, not acquiring any building, would have a $660,000 cost for land and $1,440,000 cost for leasehold, but the tenant (already owning the building) buying the fee is not acquiring a leasehold and since the reversionary interest of the building would be zero, would have a cost basis of $2,100,000 for the land if no deduction were allowed for that part of

the payment in excess of the value of the land. So the same land valued at $600,000 to one taxpayer would be valued at $2,400,000 to another taxpayer.

Petitioner contends that the amount to be allowed as a deduction in 1945 under Section 23(a) or (f) of the Internal Revenue Code of 1939 is $1,440,000. The court below erred when it inferred that the value to be attributed to the land must consider the building thereon for the purpose of determining the amount of the excess payment at the time the fee was purchased in 1945.

If one buys land for $600,000 and constructs thereon a building costing $3,000,000, there is no requirement to revalue the land and transfer part of the building cost thereto, and reduce the building cost accordingly.

Similarly, should this property be sold to another entity at a price of $3,660,000 immediately after the completion of the building, the basis to the purchaser would most certainly be $660,000 for the land and $3,000,000 for the building.

The petitioner submits that any value attributed to the land because of a building erected thereon makes the land a wasting asset, which is not contemplated by the Internal Revenue Code. There is no question that the building will eventually be of no economic value and therefore the land some day will be worth only the value of the land without any offsetting value for a building. To attribute an increased value to the land because of such a condition and not permit depreciation thereon means a taxpayer has a wasting asset, concurrent with the depreciation of the building, which is not going to be recovered taxwise. This is contrary to every accounting principle and to the very meaning of Section

23(1) of the Internal Revenue Code of 1939 and the Regulations promulgated thereunder.

The foregoing illustrates the fallacy of the thinking of the court below. Furthermore, it must be evident that a value of $660,000 for a piece of land 100 ft. by 200 ft. takes into consideration the use to which such land is put. Only an adequate improvement to be made would justify such a price of $6,600 per front foot.

If the reiterated admonition of the Supreme Court that "one of the basic aspects of the Federal income tax is that there be an annual accounting of income" is to have validity, the petitioner's payment of $1,440,000 must be deductible in 1945 and in no other year. *Healy* v. *Commissioner of Internal Revenue*, (1953) 345 U. S. 278; *Reo Motors, Inc.* v. *Commissioner of Internal Revenue*, (1950) 338 U. S. 442; *Heiner* v. *Mellon*, (1938) 304 U. S. 271.

II.

ALTERNATIVELY TO THE FIRST ISSUE, THE PETITIONER-LESSEE IS ENTITLED TO AMORTIZE THE EXCESS OF THE PAYMENT OF $2,100,000 OVER THE DETERMINED VALUE OF THE LAND OF $660,000 OVER THE REMAINING TERM OF THE EXTINGUISHED LEASE, A PERIOD OF 21-YEARS.

If the petitioner is in error in its contention that the excess of the payment of $2,100,000 over the determined value of the land of $660,000 was just to rid itself of an obligation (which does not give rise to any asset) and is an allowable deduction in the year of payment, it must follow that the payment has given the taxpayer some financial rights or interest it did not have before, and that this fi-

nancial interest arising from the cancellation of the lease will benefit the petitioner's earnings during the next 21 years by eliminating a recurring rent expense of $118,840 per annum and then be exhausted.

The land investment of $660,000 entitled the petitioner to a rent saving of between $35,000 and $40,000 per year (fair rental value). The saving of the balance of approximately $80,000 per annum as well as the elimination of substantial contingent liabilities were effected by the payment of $1,440,000. This payment is similar to or in the nature of prepaid rent which item unquestionably would be deductible in the years applicable. Treating this payment in such a manner reflects true economic income from the property each year and is in accord with sound accounting practices.

Whether the excess payment of $1,440,000 be designated as prepaid rent or a capital investment, there is no question that said amount does represent a financial interest which will be consumed in benefits over the period of 21 years. As the Supreme Court stated, in *Detroit Edison Co. v. Commissioner of Internal Revenue*, (1943) 319 U. S. 98:

> "The end and purpose of it all (depreciation) is to approximate and reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of its capital assets. For this purpose, it is sound accounting practice annually to accrue as to each classification of depreciable property an amount which at the time it is retired, will with its salvage value replace the original investment therein."

The Courts in varying instances have accepted the principle of amortizing a payment over the period benefited although the payment effected the termination of an interest

in intangible property rights. *Laird Bell* v. *Carter H. Harrison* (1954) 212 F. 2d 253; *Clara Hellman Heller Trust et al.* v. *Commissioner of Internal Revenue* (1946) 7 T. C. 556; *Henry B. Miller* (1928) 10 B. T. A. 383.

CONCLUSION

For the reasons stated, the decision of the court below should be reversed with respect to the issues before this Court and the amount of $1,440,000 be allowed as a deduction in 1945 or, alternatively, amortized and allowed as deductions over the 21-year period of the extinguished lease.

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SUPREME COURT, U. S.
FEB 15 1956
HAROLD B. WILLEY, Clerk

IN THE

Supreme Court of the United States

October Term, 1955

No. 255

MILLINERY CENTER BUILDING CORP.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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In The

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Millinery Center Building Corp.,
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v.

Commissioner of Internal Revenue,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY BRIEF FOR THE PETITIONER

I.

The respondent in his brief on the merits fails to recognize that the questions that the Court has agreed to review require something more than mere assertions to establish the law to be applied to the facts of this case.

The respondent first asserts that the amount paid to the landlord by the taxpayer to purchase the fee and cancel the lease was a capital expenditure and then argues that capital expenditures must be depreciated over the economic useful life of the asset.

But it is the very question of capital expenditures versus ordinary and necessary deduction that is at issue. Taxpayer does not contend that cost of capital assets may be deducted in the year of acquisition. With the illustrations given by respondent on page 11 of his brief, the taxpayer has no dispute; it does not contend otherwise. But the facts in those illustrations and the precept of law applied thereto do not fit the facts in the instant case. The facts in *Herzberg* v. *Alexander*, 5 F. Supp. 334, *Boos* v. *Commissioner*, 30 B. T. A. 882, and *Post* v. *Commissioner*, 109 F.2d 135, have already been distinguished in petitioner's brief. It should be noted, however, that respondent's brief statement of facts in the *Post* case is misleading since the property in that case was transferred by the lessor-owners to a new tenant-corporation owned by the lessors who received all of the stock and securities of the "purchasing" corporation. Furthermore, the demolished old buildings of the lessor had been replaced by a new modern building by the original tenant and the lessor instead of an economic loss had in fact a real economic gain.

The respondent questions that the terms of the lease were in fact onerous or unreasonable. The language of the Tax Court was plain on this point when it stated: "Petitioner purchased the fee to be released from the terms of the lease. Petitioner was most concerned about the annual rental of $118,840, which it deemed excessive, and the contingent liability to remove the building from the premises at the expiration of the lease upon the request of the landlord." (R. 5)

The original lease called for a renewal rent equal to 6% of the value of the land, vacant and unimproved, in 1945, but not less than the basic rent of $100,000 plus $18,840.

(R. 5) If not for the minimum rent clause, the renewal rental would have been 6% of $650,000, or $39,000. Competent, authoritative and uncontradicted evidence set the fair market ground rental in 1945 between $35,000 and $40,000.

Petitioner urges that as a matter of law a condition in a lease which requires the tenant to pay three times the fair rent for the premises or to forfeit a building which tenant constructed and owned at a cost of $3,000,000 and still had an agreed remaining economic life of 30 years, must be deemed, by its very requirement, to conclusively establish a burdensome or unreasonable lease.

Fine phrases and glittering generalities gleaned from other cases or illustrations involving different facts cannot convert a payment to get rid of such a lease from an expense into a capital expenditure. It was to rid itself of this burden of excessive rent as well as other catastrophic contingencies which induced the taxpayer to pay $2,100,000 for land worth $660,000. Certainly petitioner was not paying such a difference for the right to use the building for an additional nine years beginning 21 years later.

Respondent's distinction of the decisions in *Cassatt v. Commissioner*, 137 F.2d 745 and *Denholm & McKay Co. v. Commissioner*, 2 BTA 444, on the ground that in those two cases the tenants gave up the premises, whereas petitioner in this case was acquiring the fee, overlooks the essential that here petitioner was paying full measure for the land of $660,000. Cases cited by petitioner in its brief adequately support the basic proposition that a single payment may encompass both the purchase of an asset and the payment of an expense, without becoming merged into one another.

Respondent's alleged principle of merger was repudiated by U. S. Court of Appeals, 6th Circuit, in *Cleveland Aller-*

ton Hotel Inc. v. Commissioner, 166 F.2d 805. The facts and issue found in that case are similar to those in this proceeding and that Court's analysis of the facts and contentions of both parties as well as its reasoning in its opinion are equally applicable here.

Respondent argues (R. B. 9) that taxpayer's contention confuses the motive of purchase with what was purchased. Petitioner replies that business motive often is determinant of the tax treatment to be accorded any transaction. This fact has been amply supported by citations in petitioner's brief. (pp. 15-17) Recently, this honorable Court held that what ordinarily would be considered capital transactions, the purchase and sale of commodity futures, were to be treated as ordinary business transactions where said transactions were associated with the conduct of regular business. *Corn Products Refining Co. v. Commissioner*, (Nov. 7, 1955).

Respondent states (R. B. 15) that "taxpayer, which was obligated to pay rental of nearly $2,500,000 over a 21-year term, purchased for $2,100,000 fee to the land upon which there was a building erected at a cost of $3,000,000. Taxpayer thereby acquired ownership of the fee and of a building having a remaining useful life of thirty years."

Respondent has, unfortunately, overlooked the fact that taxpayer was the one who had erected the building and was already the owner of it. The taxpayer did not have to pay again in 1945 to acquire its ownership. While taxpayer's ownership in the building was subject to a lease, the lease still had 21 years to run and the taxpayer was enjoying the possession and use of such building. Even the additional nine year life after expiration of the 21-year lease was available to the taxpayer who at its option could renew the lease

for an additional 21 years. No purchase price for the building was required in 1945. The payment in excess of the value of the land of $600,000 was to save the very $2,500,000 rent referred to by respondent which was due over the next 21 years.

Respondent's statement that taxpayer's payment of $2,100,000 was in part for land likewise overlooks the fact that taxpayer had under its lease the complete use and enjoyment of the land for 21 more years and an option to renew for an additional 21 years. The only interest of the landlord in the fee that could be sold to and enjoyed by any purchaser was its use and enjoyment after the termination of Millinery Center lease at least 21 years later and possibly 42 years later. That this is so was recognized by Court below when it stated the taxpayer acquired a reversionary interest in the land. (R. 19).

Respondent argues (R. B. 16) that it is incontestable that taxpayer has acquired the right to use the building for the rest of its useful life and by deducting depreciation in each year the taxpayer will report undistorted income. As aforestated, taxpayer had the right to use its own building under the lease for at least 21 years. With regard to respondent's desire for undistorted income, the "right hand apparently does not know what the left hand is doing." The Office of Chief Counsel of Internal Revenue Service has advised the taxpayer that it interprets the decision of the Court below to give the taxpayer a building valuation of approximately $185,000 to spread over 30 years. Such amount is the alleged reversionary value of the building 21 years later with a remaining life of 9 years, discounted at 5% per annum to arrive at present value. Such treatment allows a depreciation deduction of approximately $6,200

per annum to offset the elimination of rent of $118,840 per annum and at the end of 30 years, taxpayer will have land costing $1,915,000 ($2,100,000—$185,000) but only worth $660,000, an unrealistic economic result. Taxpayer considers such contemplated treatment by respondent as being extremely distorted.

II.

Respondent misinterprets the taxpayer's theory of depreciating that part of payment of $2,100,000 in excess of the value of land of $660,000 over a 21-year period. Respondent's illustration of assumed purchase of property in March 1945, one month before the expiration of the first term of the original lease, may be analyzed as follows:

Taxpayer owns a valuable building worth about $1,800,000 which taxpayer will lose in one month unless it does something. That something is either to buy the fee or renew the lease. It buys the fee. The amount paid in excess of the value of the land then was to protect what it already owned, the building, and not to acquire a new asset. A payment made in the course of business to protect what one has as distinguished from acquiring a new asset may be deducted as an ordinary and necessary expense in accordance with Section 23 of I. R. C. The deduction in one year would not be as depreciation as stated by respondent.

An alternative construction that may be placed upon such a purchase of the property is that the excess payment was made to avoid renewing the lease and incurring aggregate rental of $2,500,000 over the next 24 years. Such a construction would also give a deduction in one year, as a payment made to avoid an unfavorable lease, a business

purpose, or be a capital asset to be amortized over 21 years, the period benefitted.

It should be noted that under the assumed set of facts, if the building were considered the asset acquired, the basis would be its relative value at time of purchase and not the present discounted value of a depreciated building 21 years hence.

Conclusion

The facts in this case, their analysis, the legal arguments in petitioner's brief as well as the arguments in this reply brief amply support the relief prayed for by the taxpayer; namely, that the amount of $1,440,000 be allowed as a deduction in 1945 or, alternatively, be amortized and allowed as deductions over the 21-year period of the extinguished lease.

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No. 258

In the Supreme Court of the United States

OCTOBER TERM, 1955

MISSOURI CRUSHED STONE CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 255

MILLINERY CENTER BUILDING CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (Pet. 20-28) is reported at 21 T.C. 817. The opinion of the Court of Appeals (Pet. 31-35) is reported at 221 F. 2d 322.

JURISDICTION

The judgment of the Court of Appeals was entered on April 14, 1955. A petition for a rehearing was denied on May 18, 1955. (Pet. 49.) The peti-

tion for a writ of certiorari was filed on July 22, 1955. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTIONS PRESENTED

1. Taxpayer, as lessee of certain land, erected a building thereon, and, after renewal of its lease, purchased the fee. The first question is whether the taxpayer could, in the year of the purchase, deduct as an ordinary and necessary business expense under Section 23 (a) of the 1939 Internal Revenue Code the difference between the price paid for the property and the value of the land vacant and unimproved.

2. If taxpayer is not entitled to such deduction, whether it can amortize this sum and certain legal expenses incident to the purchase agreement over a period of 21 years, inasmuch as the renewed lease would have run for that period if it had not been cancelled at the time of the purchase.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In general.*—All the ordinary and necessary expenses paid or incurred during

the taxable year in carrying on any trade or business * * *.

* * * * *

(l) [as amended by Sec. 121 of the Revenue Act of 1942, *supra*] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

STATEMENT

The pertinent facts as found by the Tax Court, (Pet. 15-29) are as follows:

Taxpayer leased land in New York City on April 30, 1924, and in accordance with the terms of the lease erected a 22-story building thereon at a cost of $3,000,000. Title to the building belonged to the taxpayer but was to vest in the landlord at the expiration of the last term of the lease at the option of the landlord. In the event of the destruction of the building by fire or other causes, the taxpayer could not abandon the lease and had to restore the building at its own cost. At the expiration of the lease or any renewal period, tax-

payer was to surrender the premises and the building to the landlord at the latter's option, free and clear of all encumbrances, without the landlord being obligated to pay for such property. (Pet. 15-16.)

The Commissioner allowed the taxpayer during the 21-year term of the original lease the entire cost of the building in annual depreciation deductions. (Pet. 27.)

Taxpayer had the option to renew the lease and did renew it on April 16, 1945, for another 21-year period. (Pet. 15-16.) The ground rent for the renewal period was to be six percent of the value of the land at the termination of each period of the lease but not less than the previous rental of $118,840. The value of the land was to be determined as if vacant and unimproved and the rent at six percent of the value of the land in May 1945 would have been less than $100,000. (Pet. 16.)

On May 11, 1945, taxpayer purchased the fee and obtained release from the obligations of the renewed lease for $2,100,000. Taxpayer purchased the fee in order to be released from the terms of the lease. (Pet. 16.) Title to the land was taken by taxpayer on June 11, 1945. (Pet. 16.) On the same day the agreement cancelling the lease was executed. (Pet. 18.) Taxpayer incurred legal fees aggregating $16,500 in connection with the purchase of the fee and the release from its obligations under the lease. (Pet. 20.)

The value of the land, vacant and unimproved,

apart from the taxpayer's building, was $660,000 when purchased by taxpayer in 1945. (Pet. 20.)

The Tax Court held (Pet. 21-28) (1) that the taxpayer was not entitled to deduct any part of the sum of $2,100,000 paid under the 1945 agreement as a business expense, (2) that the taxpayer could not amortize any part of such sum over the 21 years during which the renewed lease would have been in force if it had not been cancelled, and (3) that the taxpayer was not entitled to treat any part of the sum paid as an addition to the cost of the building which it had erected on the land as lessee, and so could take no additional depreciation because of payments under the agreement.

The Court of Appeals agreed with the Tax Court on the first and second points but held on the third point that the taxpayer had purchased a reversionary interest not only in the land but also in the building, and was entitled to allocate a part of the purchase price to the building to be deducted as depreciation. The Court of Appeals found that it could not determine how much should be allocated to the building since the record showed only the value of the land in its unimproved state and not its present value. Accordingly, the case was reversed and remanded for the Tax Court to determine the amount to be depreciated. (Pet. 32-35.)

DISCUSSION

We believe that the courts below were correct in holding (1) that the taxpayer was not entitled to deduct the asserted difference between the pur-

chase price of the fee and the value of the land as an ordinary and necessary business expense, even if the lease was onerous, and (2) that the taxpayer could not amortize this difference over the remaining years of the cancelled lease. However, the Court of Appeals for the Sixth Circuit, on substantially identical facts, has held that the lessee-purchaser is entitled to the business-expense deduction the taxpayer here was denied. *Cleveland Allerton Hotel v. Commissioner*, 166 F. 2d 805. Both the court below (Pet. 33) and the Tax Court (Pet. 24) have recognized that their conclusion in the instant case is contrary to that of the Sixth Circuit. In view of this conflict, and because the problem presented bears on the fundamental criteria for distinguishing under the tax laws between capital expenditures and ordinary expenses, we do not oppose the granting of certiorari.

While the conflict, strictly speaking, affects only the first of the questions petitioner presents, the nature of the problem is such that denial of the expense deduction logically entails a determination of what depreciation allowance, if any, is proper. Accordingly, we do not propose that the writ be limited to the first question. It is to be observed, however, that the taxpayer prevailed on the third question stated in its petition (Pet. 2)—*i. e.*, it was allowed by the Court of Appeals to depreciate the value of the building over its remaining economic life—and we do not seek review of this determination. Since there is thus no issue

here as to the correctness of the decision below on this question, there is no occasion for this Court to reach and review it.

CONCLUSION

For the reasons stated, we do not oppose the granting of certiorari limited to the first two questions the petition states—namely, whether the taxpayer was entitled (1) to the expense deduction it claimed or (2) to depreciate the difference between the cost of purchasing the fee and the value of the land over the remaining years of the cancelled lease.

Respectfully submitted.

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No. 255

In the Supreme Court of the United States

OCTOBER TERM, 1955

MILLINERY CENTER BUILDING CORP., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 255

MILLINERY CENTER BUILDING CORP., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 1-15) is reported at 21 T.C. 817. The opinion of the Court of Appeals (R. 16-19) is reported at 221 F. 2d 322.

JURISDICTION

The judgment of the Court of Appeals was entered on April 14, 1955. (R. 20.) A petition for rehearing (R. 20-28) was denied on May 18, 1955. (R. 29.) The petition for a writ of certiorari was filed on July 22, 1955, and was granted on October

10, 1955, limited to questions 1 and 2 presented in the petition for the writ. (R. 29-30; 350 U.S. 820.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTIONS PRESENTED

The order granting certiorari (R. 29-30) limits review to questions 1 and 2 presented in the petition for a writ of certiorari, which read as follows:

"1. Where a lessee, the owner of a valuable building on leased land, acquires the fee to the land to be relieved of what it considers to be the burdensome terms of a lease, may the lessee deduct the excess of the payment over the determined value of the land at the date of purchase as an ordinary expense of doing business under Section 23 (a) of the United States Internal Revenue Code of 1939 or under Section 23 (f) as a loss on a transaction entered into for profit and not compensated for by insurance or otherwise?

"2. In the alternative, may the lessee-petitioner consider the excess payment over the determined value of the land to be in the nature of a prepayment of rent for the remaining term of the extinguished lease and amortize such amount over 21 years?"

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In general.* All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *

* * * * * *

(f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * * *

(l) [as amended by Sec. 121 of the Revenue Act of 1942, *supra*] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

STATEMENT

The pertinent facts as found by the Tax Court are as follows:

Taxpayer leased land in New York City on April 30, 1924 and in accordance with the terms of the lease it erected a 22-story loft building at a cost of $3,000,000. Title to the building, improvements and fixtures belonged to taxpayer but was to vest in the landlord, at the expiration of the last term of the lease, at the option of the landlord. In the event of the destruction of the building by fire or other causes, taxpayer could not abandon the lease and was required to restore the building at its own cost. At the expiration of the lease or any renewal period, taxpayer was to surrender the premises and the building to the landlord at his option, free and clear of all encumbrances, without the landlord being obligated to pay for such property. (R. 4.)

The Commissioner had allowed taxpayer, during the 21-year term of the original lease, the entire cost of the building in annual depreciation deductions. (R. 13-14.)

Taxpayer had the option to renew the lease for two successive 21-year periods and did renew its lease, on April 16, 1945, for another 21-year period. (R. 4-5). Under the lease, the ground rent for the renewal period was fixed at six per cent of the value of the land as of the termination date of the prior term, but was to be no less than the previous rental of $118,840. The value of the land was to be determined as if vacant and unimproved, and the rent at six per cent of the value of the land in May 1945 would have been less than $100,000. (R. 5.)

On May 11, 1945, taxpayer entered into an agree-

ment of sale with Wendel Foundation, the owner of the land. Taxpayer purchased the fee and obtained release from the obligations of the renewed lease for $2,100,000. Taxpayer purchased the fee with a view to securing release from the terms of the lease. It was most concerned about the annual rental of $118,840, which it deemed excessive, and about the contingent liability to remove the building from the premises at the expiration of the lease upon the request of the landlord. (R. 5.)

Title to the land was taken by taxpayer on June 11, 1945. (R. 5). On the same day, the agreement of cancellation of the lease was also executed. (R. 6.) The value of the land, vacant and unimproved, was $660,000 as of the time of the purchase. (R. 8.) Taxpayer also incurred legal fees aggregating $16,500 in connection with the transaction. (R. 8.)

The Tax Court held (R. 9-15): (1) that taxpayer was not entitled to deduct any part of the sum of $2,100,000 paid under the 1945 agreement, or any part of its legal fees, as a business expense; (2) that taxpayer could not amortize any part of the purchase price over the 21 years during which the renewed lease would have been in force if it had not been cancelled; and (3) that taxpayer was not entitled, for purposes of depreciation deductions, to treat any part of the sum paid under the agreement as an addition to the cost of the building.

The Court of Appeals agreed with the Tax Court on the first and second points. It held, however, on the third point, that taxpayer, in purchasing

the fee, had acquired a reversionary interest in the building; that it was accordingly entitled to allocate a portion of the purchase price to the building; and that the sum so allocated could be depreciated during the remaining economic life of the building. The Court of Appeals found that it could not determine how much of the purchase price should be allocated to the buildings, since the record showed only the value of the land in its unimproved state. Accordingly, the cause was remanded for the Tax Court to determine the amount, representing additional cost of the building, which may be recovered through yearly depreciation deductions.[1] The Tax Court was directed to make a similar adjustment with respect to the legal fees incurred by taxpayer in connection with the purchase. (R. 16-20.)

SUMMARY OF ARGUMENT

I

In April 1945, taxpayer renewed, for a 21-year period, a lease covering land upon which taxpayer had previously erected (in accordance with the lease's requirements) a valuable building. Less than a month later, it bought out the landlord, extinguishing the lease. It thus acquired (1) fee title to the land and (2) absolute ownership of the

[1] Taxpayer assumes in most of its argument that the value of the land in its unimproved state (*i.e.*, $660,000) should be taken as its value on the date of purchase. The Court of Appeals found, however, that it was necessary, on the state of the record, to remand to the Tax Court for a determination of the land's value on the date of purchase. (R. 19.)

building which, under the lease, was to become the property of the landlord upon termination of the lease.

Both the fee to the land and the remaining property interests acquired in the building (which had a remaining useful life of 30 years) are capital assets of the classic variety. Taxpayer recognizes that the portion of the purchase price allocable to the land must be treated as a capital expenditure. But it would treat the balance as a payment made to escape an onerous lease, and it seeks to deduct this amount as an ordinary business expense of the year 1945. Apart from the fact that the rental fixed by the lease was not in fact found onerous, the argument is defective. Capital expenditures are frequently made by a business enterprise to eliminate recurrent expenditures or obligations which would otherwise have to be met. The acquisition of a capital asset is no less a capital expenditure because it has this effect. On the contrary, the hallmark of a capital acquisition is that the benefits derived therefrom will extend over a period of years. Whether viewed from the standpoint of savings incident to lease termination or from the standpoint of the productivity of the building acquired, it is plain that the benefits of this taxpayer's purchase will be realized over the course of years and that there is no sound basis, either in economics or in tax law, for attributing a disproportionate part of the purchase price to the year 1945. All of the authorities support this view with the exception of *Cleveland Allerton Hotel* v. *Commissioner*, 166

F. 2d 805 (C.A. 6th), a case which the courts below considered and believed to be unsound.

To the extent that the purchase price is allocable to the purchase of an interest in an exhaustible asset, *i.e.*, the building, the Court of Appeals has held that taxpayer may write off the expense by taking deductions for depreciation over the remaining useful life of the building. Taxpayer is plainly entitled to no more. It may not write off in one year a capital asset with a remaining life of many years.

II

Alternatively, taxpayer suggests that the portion of the purchase price allocable to the building should be depreciated over the unexpired term of the extinguished lease (approximately 21 years). But the effect of the purchase was not merely to end a contractual obligation having 21 years to run; taxpayer thereby acquired unlimited ownership of a building with a remaining useful life of 30 years. On ordinary principles of depreciation, incorporated in the Internal Revenue Code, the added investment which taxpayer made in the building in 1945 must be depreciated over the remaining life span of the building.

ARGUMENT

I

No Portion of the Sum Paid under the Purchase Agreement Can Be Deducted by the Taxpayer as an Ordinary and Necessary Business Expense

This case involves the proper tax treatment of a portion of the $2,100,000 paid by taxpayer under

the purchase agreement of May 11, 1945. Both courts below held that the entire sum of $2,400,000 was used for the purchase of capital assets and that, therefore, no part thereof could be deducted as an ordinary business expense. Taxpayer agrees that the amount paid for the land was a capital expenditure, and hence non-deductible, but it contends that a substantial sum ($1,440,000 or some other sum to be determined) was paid for the cancellation of the lease and that this sum should be deducted as an ordinary and necessary business expense under Section 23(a) of the Internal Revenue Code of 1939, *supra*, p. 3.[2]

Taxpayer's contention confuses the motive of the purchase with what was purchased. It ignores the fact that, by the payment of $2,400,000, it not only acquired fee title to the land, but also full ownership of the building which it had been required to erect and maintain under its lease. Prior to the purchase of the property, taxpayer's only interest was a right to possess the land as lessee and to hold title to the building as specified in the lease. The landlord, as the Court of Appeals held (R. 19), not only had title to the land but a reversionary interest in the building. This is plain from the terms of the lease. Thus, the lease states that at the expiration of the demised term (or other sooner ter-

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[2] Taxpayer also asserts, in the alternative, that it is entitled to deduct the $1,440,000, or some determined sum, as a loss under 1939 Code Section 23(f), *supra*, p. 3, but does not argue the point. The courts below did not discuss it. It is apparent that, if the entire purchase price was a capital expenditure, this contention also falls. Accordingly, it will not be separately treated.

mination because of the lessee's default) title to the building and to other improvements and fixtures on the land shall, at the option of the landlord, vest in the landlord and its successors and become its "property free from any and all right, title or interest of the Tenant, its successors or assigns therein." (R. 37.) Moreover, in order to protect the landlord's interest, taxpayer was required to maintain the building in good condition at its own expense and, in the event of the destruction of the building in whole or in part, to rebuild that which was destroyed. At the expiration of the lease, it was the lessee's duty to surrender the premises and the building without any cost to the landlord. (R. 36-44.)

This situation was basically changed as a result of the purchase agreement. (R. 30-34.) Taxpayer, having certain rights in the property under the lease, thereupon bought up all remaining interests. It thus acquired not only fee title to the land covered by the lease, but also full ownership of a valuable building with a remaining useful life of 30 years. (R. 12.) As the court below said (R. 18), taxpayer is in the same position as if it had bought out the share of a co-owner, or an overriding easement, or a piece of land next door.

Because taxpayer also happened to be the lessee under the lease, its purchase resulted in the merger of the leasehold in the fee, and gave it a good bargain. But while that fact may explain in large measure the motivation for taxpayer's investment, it cannot change the fundamental nature of the

transaction: taxpayer was making a substantial investment to acquire capital assets of the classic variety—land and building.

Taxpayer's brief relies heavily upon the Tax Court's finding that taxpayer deemed the rental fixed by the lease excessive and was anxious to terminate that obligation. We note parenthetically that the Tax Court did not find (although taxpayer assumes) that the lease terms were in fact onerous or unreasonable, and that the Court of Appeals stated (R. 18) that the evidence in this respect was "doubtful at best." There is, in any case, a fundamental objection to taxpayer's assumption and to the arguments which are built upon it. It is almost invariably true that, when an operating business enterprise buys realty or adds to plant or productive equipment, it is motivated by the expectation of reduced costs and obligations over the course of future years. If a manufacturer decides to buy a fleet of trucks to carry his products in order to dispense with the necessity of patronizing common carriers, presumably he makes his decision in the expectation that the annual savings will more than compensate for the capital expenditure. This does not enable him to treat the capital expenditure as an "ordinary" expense incurred in lieu of meeting routine transportation charges. Indeed, it is the fact that the savings effectuated will be realized over the course of years, and not merely during the year of the outlay, which attests to the capital nature of the transaction.

It is, of course, a fundamental precept of tax

law that money spent to acquire income-producing property or property which will be of benefit to taxpayer's business in future years is a capital expenditure and not an ordinary and necessary business expense. *Willcuts* v. *Minnesota Tribune Co.*, 103 F. 2d 947, 951 (C.A. 8th), certiorari denied, 308 U. S. 577; *Hotel Kingkade* v. *Commissioner*, 180 F. 2d 310, 312 (C.A. 10th); 4 Mertens, Law of Federal Income Taxation, Sec. 25.20. Also, see *Herzberg* v. *Alexander*, 5 F. Supp. 334 (W.D. Okla.), and *Boos* v. *Commissioner*, 30 B.T.A. 882, holding that where a lessee acquires fee title to property covered by a lease before the cost of such lease is fully amortized he may not deduct the unamortized cost as a loss or business expense but must treat such amount as a capital expenditure. And cf. *Post* v. *Commissioner*, 109 F. 2d 135 (C.A. 2d), holding that a lessor-owner on selling property to a person who had previously purchased the lease covering such property from the lessee, could not deduct the unamortized cost of the lease as a business expense, but had to include such sum as a part of the cost of the property which was sold.

We submit that the conflicting decision in *Cleveland Allerton Hotel* v. *Commissioner*, 166 F. 2d 805, (C.A. 6th), which alone gives comfort to taxpayer, is erroneous.[3] The cases upon which the Sixth

[3] Both the court below and the Tax Court recognized that the *Cleveland Allerton* decision was inconsistent with the result reached in the instant case. In that case, the owner of a valuable hotel located on leased land bought the fee for $441,250 in the year 1941, extinguishing a 99-year lease which

Circuit relied, *Vassiff v. Commissioner*, 137 F. 2d 745 (C.A. 3d), and *Penfield & McKay Co. v. Commissioner*, 2 B.T.A. 444, are both clearly distinguishable. Neither of the lessees in those cases purchased the fee to the leased property. Each was seeking, and each secured, the cancellation of his lease for an agreed sum of money. Since each surrendered possession of the leased property, it is evident that neither acquired a capital asset.[4]

This distinction, which taxpayer would obliterate, is basic and rests on sound principles. Let us suppose, for example, that two businessmen, *A* and *B*, lease similar pieces of property, each for a term of ten years. After the expiration of a year, *A* decides that it is necessary to move this business to another location. Accordingly, he settles his obligation under the lease for an agreed sum and pays that sum to the landlord. *B*, on the other hand, decides, after a brief experience as lessee, that he wishes to make permanent use of the property in

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had 80 years to run. Taxpayer contended that the rental fixed by the lease was excessive and that the purchase price of the land, which was influenced by the lease obligation, was similarly so. The Court of Appeals held that the fair value of the land was $200,000 and that the difference between this amount and the purchase price might be deducted as a business expense of the year 1941. See discussion of case in Note, 48 Col. L. Rev. 965.

[4] *Hort v. Commissioner*, 313 U.S. 28, cited by taxpayer (Br. pp. 12, 14), is similarly inapposite. There, the sum of money which taxpayer-lessor received upon the cancellation of a lease was held to be in lieu of rent and taxable as ordinary income. But the taxpayer there had sold no capital asset and was in an entirely different position from that of the lessor which made the sale to taxpayer here.

question and that it will be sound economics for him to buy out the landlord. Accordingly, he strikes a bargain with the landlord and buys the fee, thus extinguishing the lease.

In A's case, it is apparent that the expense incident to securing a release is identified with the tax year in which the settlement is made. It is a necessary expense, in the nature of damages, incurred at the time of settlement. From that point forward, A will have no further connection with the property.

In *B*'s case, however, the tenant is not severing his connection with the property. On the contrary, *B* is increasing his interest in the property so that he will have the incidents of full ownership rather than the lesser rights of a tenant for a term of years. In this circumstance, there appears to be no sound reason why his purchase of the fee should be treated differently from the case of anyone else who buys a piece of productive property or an interest in such property. It may be that the nature of *B*'s business was such that he had special need for the particular site and that the landlord was, therefore, able to obtain a higher price in selling the fee to *B* than he would have been able to secure from a third party. It can hardly be suggested, however, that a portion of *B*'s investment in the fee should, therefore, be deemed a business expense chargeable to the year the purchase was made. The tax laws must proceed upon the basis of certain objective facts. If the asset purchased is of a kind that the benefits which

the purchaser derives therefrom will extend far beyond the taxable year, the expenditure must certainly be treated as a capital expenditure, irrespective of the motives and other intangible factors which led the buyer to make the particular purchase at the particular price at the particular time.

The same is true in the instant case. In April 1945, taxpayer voluntarily renewed a lease, thereby obligating itself, under the terms of the agreement, for a 21-year period. Less than a month later, taxpayer bought out the landlord. Stated more fully, taxpayer, which was obligated to pay rental of nearly $2,500,000 over a 21-year term, purchased for $2,100,000 fee to the land upon which there was a building erected at a cost of $3,000,000. Taxpayer thereby acquired ownership of the fee and of a building having a remaining useful life of thirty years. Yet, it is taxpayer's position (at least in its most extreme form) that, except for the value of the unimproved land, this expenditure is to be deemed a business expense entirely attributable to the year 1945.

Taxpayer says in substance that it executed the renewal, notwithstanding the fact that it deemed the ground rental high, because otherwise it would have been required to abandon the valuable building appurtenant to the land. But this fact, which may be conceded, serves only to underscore the correctness of the Court of Appeals' decision: that taxpayer was buying two things—title to the land and a valuable reversionary interest in the build-

ing. As to the land, taxpayer recognizes that the value which it represents must be treated as a capital expenditure. As to the amount which is allocable to the building, the Court of Appeals held that it could be depreciated over the remaining depreciable life of the building. The holding that this amount shall be spread over that period, and not deducted in the year 1945, rests on the incontestable proposition that taxpayer has acquired the right to use the building for the rest of its useful life. Under the decision, taxpayer, like any other owner, will be able to deduct, each year, the wear and tear upon the building for that year, and it will report undistorted income. Taxpayer's contention, if upheld, would result in gross distortion of income, not only in the year of purchase, but in subsequent years as well. For if the amount allocable to the building is deducted in 1945, the effect would be the same as if one were to depreciate overnight a property interest which will actually depreciate in value (so far as one can reasonably estimate) over the course of thirty years.[5]

Taxpayer cites cases holding that a lump-sum payment may include both a business expense and a capital expenditure, but none of these cases involves facts similar to those here.[6] Moreover, there

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[5] Taxpayer's theory would similarly distort the cost basis of the property in the event of a resale.

[6] See *Commissioner* v. *Stuart Co.*, 195 F.2d 176 (C.A. 9th), in which a payment in settlement of litigation was divided into a payment for a trade-mark (capital expenditure) and payment for canceling a contract to distribute vitamins; *Lomas & Nettleton Co.* v. *United States*, 79 F. Supp. 886 (D.

is nothing in *Commissioner* v. *Moore*, 207 F. 2d 265 (C.A. 9th), certiorari denied, 347 U.S. 942, to sustain taxpayer's contention that it incurred any deductible business expense in connection with its purchase. The taxpayer there, who had been half owner of the leased property for some years, inherited the other half from her mother. She contended that the element of value attributable to the fact that the outstanding lease was favorable at the time she inherited the remaining interest should be amortized over the period of the lease. The court held that if the lease was in fact a favorable one such favorable aspects were a wasting asset and could be amortized. In so holding, it treated the taxpayer's inherited interest like a purchase of a lease and considered such interest as a capital asset separate from the interest in the land. But see *Friend* v. *Commissioner*, 119 F. 2d 959 (C.A. 7th), certiorari denied, 314 U.S. 673. In the instant case, under the Court of Appeals' decision, the asset which may be regarded as a wasting asset, *i.e.*, the building, may be similarly depreciated over its life span.

In summary, the essence of the present case is this. Taxpayer has made an investment which gives it additional and substantial property inter-

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Conn.), involving a sum paid by taxpayer to a receiver for certain assets and for expenses incurred by the receiver in settlement proceedings; *Olympia Harbor Lumber Co.* v. *Commissioner*, 30 B.T.A. 114, in which a lump sum paid by taxpayer was found to be payment for certain equipment and for cancellation of a business contract involving the performance of work for taxpayer.

osts. It may be assumed, as taxpayer in substance asserts, that it was to taxpayer's advantage to end its long-term lease obligation and to become an absolute owner of land and building. The fact remains that the savings represented by this advantage will be realized over the course of years. It follows that the expenditure which converted taxpayer's interests to ownership interests must be treated as capital in nature and as subject to the ordinary rules governing depreciation.[7]

II

The Court of Appeals Correctly Held that the Portion of the Purchase Price Allocable to the Building Is To Be Depreciated Over the Period of the Building's Remaining Useful Life

Accepting, *arguendo*, the Court of Appeals' holding that the entire purchase price represented a capital investment, taxpayer argues, alternatively, that it is entitled to amortize the portion of the investment allocable to the building over the unexpired period of the extinguished lease (approximately 21 years).[8] The Court of Appeals held, we

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[7] If one assumes, *arguendo*, that taxpayer paid more than a third party would have paid, it would seem that to this extent, taxpayer was capitalizing its lease obligations in the course of acquiring the additional property interests. But the conclusion that it was making a capital expenditure remains unchanged.

[8] As observed above (note 1, p. 6), taxpayer appears to assume in its brief that this dollar amount has been determined. The Court of Appeals held, however (R. 19), that "[c]n the present state of the record we cannot determine how much of the $2,100,000 purchase price is properly to be allo-

believe correctly, that the amount allocable to the building is to be depreciated over the remaining life span of the building (30 years).

We note, at the outset, that taxpayer's contention, if accepted, would lead to absurd results. Taxpayer made the investment which gave it unlimited rights in the building in May 1945, one month after it renewed the lease for a 21-year term. Let us suppose for the moment, however, that taxpayer had made the purchase, on the same terms, in March 1945, one month before the original term of the lease expired. This would mean, on taxpayer's theory, that the added investment in a building with a remaining useful life of 30 years would be deducted as depreciation in a single year.

When one buys a capital asset (or an interest in a capital asset) which has a remaining useful life of 30 years, it follows, by definition, that it should be depreciated over that period. The depreciation allowed by the Code is "a reasonable allowance for * * * exhaustion, wear and tear." (Sec. 23(l), *supra*, p. 3.)

If *A* is a lessee of land for a term of years and he erects a building on the premises which will outlast the lease and revert, at the expiration of the term, to the landlord, he is, of course, entitled to amortize the cost of the building over the term of

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cated to the land and how much to the building." It accordingly remanded for a determination on this point. Since it is plain that this determination should be made by the Tax Court, we address ourselves solely to the question whether the amount ultimately determined to be allocable to the building is to be spread over the 21- or the 30-year period.

the lease.[9] In such circumstances, the tenant's right to use the building is necessarily limited by the prescribed term of years and it is of no avail to him that the building will last longer than the lease term. But taxpayer here, by its added investment, changed its position from that of one whose rights of enjoyment are limited in time to that of one who has the full and perpetual rights of ownership. The additional investment in the building gives taxpayer the right and the opportunity to use the building so long as it remains usable. And the benefits or savings incident to ownership will be realized over this span.[10] Cf. *Cassatt* v. *Commissioner*, 137 F. 2d 745, 749 (C.A. 3d.), and *Post* v. *Commissioner*, 109 F. 2d 135 (C.A. 2d).

Bell v. *Harrison*, 212 F. 2d 253 (C.A. 7th); *Clara Hellman Heller Trust No. 7610* v. *Commissioner*, 7 T.C. 556, and *Miller* v. *Commissioner*, 10 B.T.A. 383, cited by the taxpayer, offer it no support. Indeed, so far as pertinent here, these cases are in accord with the decision below. In each, it was held that sums paid to acquire the use of property for a given period might be amortized over that period. Here, taxpayer, before making the pur-

[9] In this case, the original $3,000,000 cost of erecting the building was amortized by taxpayer over the 21-year period of the original lease term. (R. 49.) This was in accord with *Bonwit Teller & Co.* v. *Commissioner*, 53 F. 2d 381 (C.A. 2d), certiorari denied, 284 U.S. 690.

[10] Note that if taxpayer had continued under the renewed lease for the balance of the 21-year term, it would have been faced, at the end of that period, with the necessity of making a further arrangement with the landlords or of abandoning the still useful building.

chase, had the right to use the property for a period of 21 years. Through the purchase it acquired the right to use the depreciable property, the building, for a longer period. The longer period was the remaining life of the building, 30 years, over which the court below has held it may be depreciated.

CONCLUSION

For the foregoing reasons, the decision of the Court of Appeals is correct and should be affirmed.

Respectfully submitted,

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